United States Court of Appeals

for the Second Circuit

SUPPLEMENTAL APPENDIX

75-7141

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P/S

United States Court of Appeals

For the Second Circuit

INDEPENDENT INVESTOR PROTECTIVE LEAGUE, *et al.*,

Plaintiffs,

against

AVCO CORPORATION, *et al.*,

Defendants.

EDDIE L. THOMPSON, JR.,

Plaintiff-Appellant,

against

ARTHUR YOUNG & COMPANY,

Defendant-Appellee.

On Appeal from the United States District Court for the Southern District of New York

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SUPPLEMENTAL APPENDIX OF DEFENDANT-APPELLEE ARTHUR YOUNG & COMPANY

WHITE & CASE
Atiorneys for Defendant-Appellee
Arthur Young & Company
14 Wall Street
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UNITED STATES COURT OF APPEALS
FILED
MAY 21 1975
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

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Notice of Appeal

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

INDEPENDENT INVESTOR PROTECTIVE LEAGUE, in behalf of its membership affected; EDDIE L. THOMPSON, JR., individually and in behalf of all persons similarly situated and circumstanced,	74 Civ. 731 (MEF)
Plaintiffs,	NOTICE OF APPEAL
-against-	
AVCO CORPORATION, et al.,	
Defendants.	

S I R S :

PLEASE TAKE NOTICE that defendant Arthur Young & Company hereby appeals to the United States Court of Appeals for the Second Circuit from such part and only such part of the Order and Judgment of Dismissal herein, entered on February 21, 1975, which failed to grant security for costs to said defendant.

Form Bank Fed. 71.1

Dated: New York, New York
March 11, 1975

Yours, etc.

WHITE & CASE

By _____
A Member of the Firm
Attorneys for Defendant
Arthur Young & Company
14 Wall Street
New York, New York 10005

TO:

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- x

INDEPENDENT INVESTOR PROTECTIVE LEAGUE, et al.,

Plaintiffs,

-against-

AVCO CORPORATION, et al.,

Defendants.

74 Civ. 731 (MEP)

NOTICE OF MOTION

- x

S I R S :

PLEASE TAKE NOTICE, that on the Affidavit of Laura Banfield, sworn to November 4, 1974, and exhibits attached hereto, and upon all prior proceedings herein, the undersigned will move this Court, by the Hon. Marvin E. Frankel, U.S.D.J., at the United States Courthouse, Foley Square, New York, New York, Room 1106 , on November 19, 1974, or as soon thereafter as counsel may be heard, for an order pursuant to Rule 56 F.R.C.P. granting summary judgment dismissing the complaint herein as to defendant Arthur Young & Company; or, in the alternative, requiring plaintiff to post security for the costs and expenses including reasonable attorneys' fees of defendant Arthur Young & Company in this action, the amount of such security to be fixed at a subsequent hearing to be had for that purpose, and awarding to said defendant such other and further relief as to the Court may appear just and proper.

Dated: New York, New York
November 4, 1974

WHITE & CASE

By Laura Banfield
A Member of the Firm
Attorneys for Defendant
Arthur Young & Company
14 Wall Street
New York, New York 10005
732-1040

TO:

BADER & BADER
274 Madison Avenue
New York, New York

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WILLIAMSON & SCHOEMAN
60 East 42nd Street
New York, New York

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

INDEPENDENT INVESTOR PROTECTIVE LEAGUE, et al., Plaintiffs,	74 Civ. 731 (MEF)
-against-	
AVCO CORPORATION, et al., Defendants.	AFFIDAVIT

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

LAURA BANFIELD, being sworn, says:

1. I am a member of the firm of White & Case, attorneys for defendant Arthur Young & Company. I make this affidavit in support of Arthur Young's motion for summary judgment or, in the alternative, for an order requiring plaintiff to furnish security for Arthur Young's costs and expenses, including reasonable attorneys' fees in this matter.

2. This action is directed, insofar as Arthur Young is concerned, to financial statements of Cartridge Television, Inc. ("Cartridge") which were included in a July 13, 1971 Prospectus and in the 1971 and 1972 Annual Reports of that company. Copies of these documents are attached to this affidavit as Exhibits A, B and C, respectively.

3. Also submitted, for the Court's convenience, are certain accounting publications referred to in defendant Arthur Young's accompanying memorandum of law in support of this motion:

Exhibit D — AICPA, Committee on Companies in the Development Stage, Preliminary Draft of Audits of Companies in the Development Stage (July 1973)

Exhibit E — FASB, Discussion Memorandum, Accounting for Research and Development and Similar Costs (Dec. 28, 1973)

Exhibit F — FASB, Proposed Statement of Financial Accounting Standards: Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components (July 19, 1974)

4. Finally, attached hereto as Exhibits G-1 through G-6, are six examples of financial statements included in effective prospectuses filed with the SEC and available as public records, of companies which, like Cartridge, were in the "development stage" for purposes of Article 5A of the SEC's Regulation S-X and whose Article 5A statements, like Cartridge's, deferred all research and preoperating costs incurred during the development stage.

/s/ Laura Banfield
LAURA BANFIELD

Sworn to before me this
4th day of November, 1974

/s/ Natalie C. Varanelli
Notary Public

Exhibit A Annexed to Affidavit of Laura Banfield
July 13, 1971 Prospectus of Cartridge Television, Inc.

PROSPECTUS

(31)

1,100,000 Shares

CARTRIDGE TELEVISION INC.

Common Stock
($1 par value)

TED ROZAR
INSTITUTIONAL SALES DEPT.
Hornblower & Weeks - Hemphill, Noyes
D. 4-66.0

THESE SECURITIES INVOLVE A HIGH DEGREE OF RISK.

Prior to this offering, there has been no established trading market for the common stock of the Company. The Price to Public set forth below has been determined by negotiation between the Company and the Underwriters through the Representative.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public	Underwriting Discounts and Commissions(1)	Proceeds to Company(2)
Per Share	$20.00	$1.80	$18.20
Total	$22,000,000	$1,980,000	$20,020,000

(1) Hornblower & Weeks-Hemphill, Noyes has agreed to pay finders' fees of approximately $20,000 each to Clarence Avant and Clyve Fox.

(2) Before deducting expenses payable by the Company estimated at $170,000. The Company has agreed to indemnify the Underwriters against certain liabilities, including liabilities under the Securities Act of 1933.

This offering involves:

(a) *Special risks concerning the Company.* See RISK FACTORS, *page 2.*

(b) *Immediate dilution in that the net tangible book value per share of the Company's common stock will be substantially less than the Price to Public on completion of this offering.* See DILUTION, *page 4.*

(c) *The issuance to Hornblower & Weeks-Hemphill, Noyes of 5-year warrants to purchase an aggregate of 50,000 shares of the Company's common stock at $24 per share.* See UNDERWRITING, *page 16.*

The Underwriters are severally offering the shares when, as and if delivered to and accepted by them and subject to their right to reject orders in whole or in part.

HORNBLOWER & WEEKS-HEMPHILL, NOYES

The date of this Prospectus is July 13, 1971.

Exhibit A Annexed to Affidavit of Laura Banfield

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE COMMON STOCK OFFERED HEREBY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZATION, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

THE COMPANY

Cartridge Television Inc. ("the Company") was incorporated in Delaware on February 2, 1971 and is the successor by statutory merger to a corporation of the same name which was organized in New York on June 27, 1968. The Company's principal executive offices are located at 1115 Broadway, New York, New York 10010, and its telephone number is (212) 255-4800. References to the Company herein include its New York predecessor corporation.

In May 1969, a majority interest in the Company was acquired by Avco Corporation ("Avco"). With the financial and technical assistance of Avco, the Company has developed a color video tape cartridge system intended primarily for home use, identified by the registered trademark "CARTRIVISION". The system, which operates with a television receiver and utilizes video tape cartridge cassettes, can record television programs off the air on blank tape and play them back, play pre-recorded programs, and make "home movies" (initially only in monochrome) with sound on blank tape by means of a special camera and play them back. The cartridges are of various lengths up to 114 minutes, sufficient to display an average full length motion picture without interruption. Non pre-recorded tapes may be erased after recording and reused.

The Company will sell recorder-playback units to manufacturers and others who will integrate the units with television receivers and sell the completed CARTRIVISION systems. The Company will be dependent upon such manufacturers to obtain consumer acceptance of the system, although it also plans to sell units directly to certain commercial, industrial and governmental customers. The Company will produce and sell or rent both blank and pre-recorded video tape cartridges for use with the system.

Prototype CARTRIVISION units have been exhibited publicly, but the Company does not expect production of the system and the cartridges to be used in connection therewith to be sufficiently advanced to permit sales to consumers of the system and cartridges before mid-1972. Because the Company will not be producing or selling the integrated system and is dependent on other manufacturers for key components of the system, there can be no assurance that this timetable will be met. For further information concerning the Company and its CARTRIVISION system, see HISTORY AND BUSINESS below.

RISK FACTORS

The common stock of the Company offered hereby involves a high degree of risk. In evaluating these securities, a prospective investor should carefully consider the following factors:

1. The Company has been in existence only three years and has had no operating revenues since its inception.

2. Numerous firms, both in the United States and abroad, are engaged, or have announced their intention to engage, in the development of home video systems which are or would be competitive with the CARTRIVISION system. Most of these companies are substantially larger and possess greater resources and more extensive operating experience than the Company.

3. As of March 31, 1971, the Company's current assets aggregated $75,966 and its current liabilities aggregated $984,681 (exclusive of certain notes payable to Avco refinanced prior to this offering as described under MANAGEMENT — Certain Transactions below), resulting in a working capital deficit of $908,715. From its inception in 1968 to March 31, 1971, the Company incurred approximately $6,076,000 of research and preoperating costs in developing its CARTRIVISION system, and it estimates that at least an additional $7,509,000 of preoperating costs must be incurred before the first units can be sold. For financial reporting purposes, research and preoperating costs will be amortized over a 36-month period commencing when sales of the Company's products are first made. (See Note 1 to the financial statements.) The Company also estimates that approximately $8,640,000 will be spent to acquire additional capital equipment and tooling before the first units can be sold.

4. To date, commercial application of video tape systems manufactured by others has been limited primarily to industrial and business uses. In view of the novelty of the home video tape system developed by the Company, the substantial estimated retail prices of CARTRIVISION units and cartridges, and the difficulty of predicting public demand for the programming which will be available for use with the system, no assurance can be given that the CARTRIVISION system will meet with general public acceptance.

5. As production and sale of the CARTRIVISION system have not yet commenced, the Company has no experience as to whether CARTRIVISION units manufactured in production quantities will operate satisfactorily under conditions of home use or whether they can be sold profitably.

6. The Company does not have, nor does it presently plan to establish, its own plants to manufacture components of the CARTRIVISION system, other than its cartridge and video head manufacturing plant located in San Jose, California. The Company must depend on making satisfactory contractual arrangements with other manufacturers to assure adequate production and sales of its system.

7. Failure by the Company to retain the services of its present key technical personnel or to attract additional qualified personnel, as required, could have an adverse effect on its operations.

8. Published reports indicate that efforts are being made by various firms in the industry to standardize the technical characteristics of the tapes and cartridges used or to be used in home video tape systems. Since no tapes or cartridges other than those being developed by the Company are presently compatible with the CARTRIVISION system, industry standardization on a different type of tape or cartridge could have a seriously detrimental effect on the Company's prospects.

9. Much of the earnings potential of the Company appears dependent upon its ability to offer customers pre-recorded tapes covering attractive subject matter. Keen competition is developing among the potential participants in this industry to conclude contractual arrangements covering a wide variety of popular programming. Because of its recent organization, small size and lack of demonstrated manufacturing and marketing abilities, the Company may be at a competitive disadvantage in obtaining satisfactory programming for the CARTRIVISION system.

10. Although the Company has filed a number of patent applications pertaining to various aspects of the CARTRIVISION system, it does not expect to obtain fundamental patent protection for

the basic concept or design of its system. No assurance can be given that patent infringement claims will not be asserted which may adversely affect the Company or that any valid patent protection will be obtained by the Company. The Company may be required to obtain patent licenses in order to produce and market the CARTRIVISION system, but no assurance can be given that such licenses can be obtained.

11. Although the Company believes that the net proceeds of this offering will be sufficient to meet its long-term financing needs, no assurance can be given that unforeseen factors, such as problems in production or marketing, may not result in a need for additional financing. The Company anticipates, furthermore, that after production and sale of the system have commenced, it will require additional bank or commercial financing for its working capital needs. No assurance can be given, however, that any such financing can be obtained or, if obtained, as to the terms thereof.

12. The Company is not in a position to pay any cash dividends on its common stock, nor is it likely to be in such a position in the foreseeable future.

For more detailed information concerning the foregoing risk factors, see HISTORY AND BUSINESS below.

DILUTION

The Company's tangible assets exceeded its liabilities (other than notes payable to Avco refinanced as described under MANAGEMENT — Certain Transactions below) by $824,279 at March 31, 1971. Adjusted to give effect to completion of this offering, the Company's tangible assets as of that date would have exceeded its liabilities by $20,674,279, providing a net tangible book value of $9.93 for each share of the Company's outstanding common stock. Accordingly, on this pro forma basis and assuming no other changes, the new public stockholders will incur an immediate dilution from the Price to Public to the post-offering net tangible book value per share of $10.07. Upon completion of the offering, the new public stockholders will own approximately 52.8% of the outstanding common shares of the Company, for which they paid $22,000,000, while the previous stockholders will own approximately 47.2% of the outstanding common shares, for which they paid $7,625,500.

USE OF PROCEEDS

The net cash proceeds to be received by the Company pursuant to this offering are estimated at $19,850,000, after deducting expenses payable by the Company estimated at $170,000. The Company will use these net cash proceeds to defray its additional preoperating costs (estimated at $7,509,000 as of March 31, 1971, of which approximately $1,173,000 will be used to reimburse Avco for startup expenses to be incurred in connection with production of CARTRIVISION recorder-playback units), to acquire additional capital equipment and tooling (estimated at $8,640,000 as of March 31, 1971, of which approximately $6,267,000 is expected to cover equipment and tooling to be located in Avco plants), to pay accrued interest and accounts payable (including amounts, $751,000 at March 31, 1971, payable to Avco), to repay $400,000 of short-term notes payable to Avco and any additional short-term borrowings which may be needed prior to the Company's receipt of the proceeds of this offering, and to provide funds to meet other operating needs of the Company. (See RISK FACTORS 3 and 11 above, HISTORY AND BUSINESS — Production below, and Notes 1 and 3 to Financial Statements.)

Exhibit A Annexed to Affidavit of Laura Banfield

CAPITALIZATION

The following table sets forth the debt and capitalization of the Company as of May 31, 1971, and as adjusted to reflect the refinancing arrangements described under MANAGEMENT — Certain Transactions below and the issuance and sale of the common shares offered hereby:

	Outstanding	As adjusted
Debt —		
Payable to Avco:		
Notes due July 15, 1971	$5,100,000(1)	$ 400,000
Notes due November 30, 1971	1,400,000	—
Notes due 1976-1977	1,000,000	—
	7,500,000	400,000
Payable to others:		
8½% secured note due to 1975	476,600	476,600
	$7,976,600	$ 876,600
Capitalization —		
Common stock (authorized(2): 630,000 no par value shares at May 31, 1971; 2,500,000 $1 par value shares as adjusted)	627,750 shs.	2,082,750 shs.(3)
Warrants expiring in 1981 to purchase one common share each	—	12,500 wts.
Warrants expiring in 1976 to purchase one common share each	—	50,000 wts.

(1) Includes $400,000 advanced to the Company subsequent to May 31, 1971.

(2) Reflects the changes in the Company's capitalization described under MANAGEMENT — Certain Transactions below.

(3) Includes 355,000 shares issued to Avco (see MANAGEMENT — Certain Transactions below) and 1,100,000 shares being offered hereby, but does not include 175,000 shares reserved for issuance pursuant to the Company's Stock Option Plan (see MANAGEMENT — Stock Option Plan below) or an aggregate of 62,500 shares reserved for issuance pursuant to exercise of the common stock purchase warrants received by Avco (12,500 shares) and Hornblower & Weeks-Hemphill, Noyes (50,000 shares). (See MANAGEMENT — Certain Transactions and UNDERWRITING below.) For the purpose of qualifying the shares offered hereby for sale under the securities laws of several states, the Company has undertaken not to grant options and warrants to purchase shares of its common stock if such options and warrants would result in there being outstanding options and warrants covering in excess of 10% of the then outstanding shares of the Company's common stock. Any future options and warrants granted in connection with certain financings and acquisitions negotiated at arm's length by the Company are excluded from the foregoing limitation.

Exhibit A Annexed to Affidavit of Laura Banfield

HISTORY AND BUSINESS

Background

On the date of its original incorporation in June 1968, Cartridge Television Inc. acquired all of the rights and interest of Playtape, Inc. ("Playtape") under an earlier contract with two individuals pertaining to the invention, design and development of a preliminary prototype home video tape recorder-playback system. Playtape has advised the Company that Playtape's aggregate capitalized costs of these rights and interest as of that date were approximately $93,000. The Company subsequently purchased all of the individuals' remaining interest in their prototype system for $72,000. The Company's agreement with Playtape specifies a basic purchase price of $120,000 (which has been paid) and provides for annual royalties equal to the lesser of $500,000 or 2% of the income of the Company derived from the CARTRIVISION system before income taxes, these royalties and the royalties payable to Avco referred to below (all of which royalties may be reduced as a result of certain patent and related contingencies) for each fiscal year in perpetuity commencing with the fiscal year beginning December 1, 1973. Certain officers and directors of the Company are also officers, directors and stockholders of Playtape (see MANAGEMENT below).

Recognizing that their recorder-playback prototype required substantial further development before its commercial feasibility could be fully determined, the principal stockholders of the Company approached Avco in the spring of 1969 with the proposal that Avco participate in such development. In May 1969, the parties executed contracts providing for (*i*) the issuance and sale to Avco of 50.2% of the Company's outstanding shares for a cash purchase price of $500,000, (*ii*) an agreement by Avco to lend the Company up to an additional $1,000,000 and to assist the Company in securing such further financing as might be required during the developmental stage, and (*iii*) an agreement by Avco's Electronics Division to provide technical and engineering assistance in further developing the CARTRIVISION system. The latter agreement provides for future royalty payments by the Company to Avco in the same amounts and on the same terms as provided under the agreement with Playtape described above, and, accordingly, royalties payable by the Company to Avco and Playtape could aggregate $1,000,000 per year if the Company's income so permitted.

Since May 1969, Avco has advanced to the Company an aggregate of $7,500,000 (see CAPITALIZATION above), of which $7,100,000 was refinanced immediately prior to the date of this Prospectus (see MANAGEMENT — Certain Transactions below).

At all times from May 1969 to the date of this offering, Avco continued to own a majority of the Company's common stock, designated four of the Company's eight directors, and was the Company's principal lender (see MANAGEMENT — Certain Transactions below).

Description of System

The CARTRIVISION system consists of a solid-state video recorder-playback unit which is integrated with a color television receiver. The system is designed to play pre-recorded cartridges in color or monochrome on the television receiver, to record either color or monochrome television programs off the air for subsequent playback without processing, and to play cartridges on which "home movies" with sound have been recorded by means of a special camera (initially to be available only in monochrome). The unit incorporates a timing device which permits television programs to be automatically recorded off the air in the absence of the set owner, enabling the programs to be viewed subsequently at the owner's convenience. Normal television viewing is available when the CARTRIVISION system is not in use or while programs are being recorded.

The CARTRIVISION system is compatible with both color and monochrome video signals. Cartridges recorded in color will produce color images when played through color receivers and

monochrome images when played through monochrome receivers. Cartridges recorded in monochrome may be played through either color or monochrome receivers, but will produce only monochrome images.

The Company has commenced development of an adaptor unit having recording and playback capabilities to be adapted to a set owner's existing television receiver, whether color or monochrome. No assurance can be given that this adaptor unit can be successfully developed or, if developed, as to when it would be available for sale to consumers.

The tape used with the CARTRIVISION system is one-half inch wide iron oxide magnetic video tape which is similar in appearance to audio tape in general current use. This tape, of various lengths, is wound in cartridges and permits up to 114 minutes of continuous playing time. The tape is erasable and has an estimated useful life in excess of 100 playings. The cartridge is designed so that it can be stopped, rewound or removed from the CARTRIVISION unit at any time. When an interrupted cartridge is reinserted in the unit, the tape continues from the point of interruption.

In the recording process, one of the system's three video heads induces on the tape a magnetic imprint which conforms to the electronic impulses derived from the picture. Sound is recorded and reproduced by separate audio heads in the same manner employed by conventional audio stereo tape recorders. For playback, the three video heads scan the video magnetic imprint sequentially, generating three picture fields from each one recorded. This technique increases by a factor of three the duration of program which can be recorded on a given length of tape, but produces a slightly less smooth image transition which could be perceptible to the trained eye under certain circumstances.

Developmental Progress

The Avco Electronics Division agreed with the Company in May 1969 to conduct feasibility studies with respect to both monochrome and color versions of the CARTRIVISION system and, if determined to be feasible, to develop a system with color capability. In August 1969, Barger Corporation of Sunnyvale, California, an unaffiliated company, agreed to develop for the CARTRIVISION system electronic circuitry for color video signals and a high-speed contact printing duplicator to produce pre-recorded tapes. This agreement provides for payment to Barger of royalties aggregating up to $300,000, based on sales of certain CARTRIVISION products.

By the spring of 1970, progress on the foregoing research program had proceeded sufficiently well to enable the Company to concentrate solely on the color version of the CARTRIVISION system. Prototype units of this version were displayed publicly at the Consumer Electronics Show in New York City in June 1970. Since that time, work has continued on improvement of the prototype version and simplification of the equipment components. In addition, a plant acquired by the Company at San Jose, California (see Plants and Properties below) is being equipped for the manufacture of cartridges, and arrangements have been completed for the production of CARTRIVISION components by Avco's Electronics Division at Huntsville, Alabama, and the assembly of complete recorder-playback units by Avco's Precision Products Division at Richmond, Indiana (see Production below).

The Company does not expect production of the CARTRIVISION system and the cartridges to be used in connection therewith to be sufficiently advanced to permit sales to consumers of the system and cartridges before mid-1972.

Competition

Various types of video tape recorders, different from the CARTRIVISION system, have been available and used for a number of years by the television industry, and a limited number are also

being produced for the industrial and general consumer markets. However, the high price and operating complexities of these devices have prevented them from becoming mass market consumer items. Currently a number of firms are devoting considerable research efforts to the development of lower cost home video systems.

To date, a number of different varieties of home video systems have been publicized. One is the magnetic tape cartridge system, of which the CARTRIVISION system is an example. Other magnetic tape systems are being developed by Sony Corporation of Japan, Ampex Corporation and Philips of Holland, among others.

A second approach is represented by Columbia Broadcasting System's Electronic Video Recording system which relies on miniaturized film coiled in a cartridge and run through a separate playback unit connected to a television set. Units incorporating this system are presently being produced by Motorola, Inc. Another proposed system is RCA Corporation's SelectaVision process based on holographic photography. Using a laser beam, RCA embosses an encoded picture on vinyl tape which is played through a module connected to a television set. Other approaches include the use of Super 8mm film in conjunction with a television set, and systems utilizing plastic discs on which the video images have been recorded in phonograph fashion.

Each of these home video systems presently being developed is incompatible with the others. In an effort to avoid the expense and consumer confusion inherent in the marketing of incompatible but competitive products, attempts are being made by certain electronics firms to standardize magnetic tape and cartridge configurations.

The foregoing information, which has been summarized from published reports and news articles, indicates that the major potential competitors of the Company and its CARTRIVISION system appear to be Sony, Ampex, Philips, CBS and RCA. Each of these companies is substantially larger than the Company and has greater financial and other resources and more extensive operating experience in electronics. If general agreement is reached by a significant number of the Company's potential competitors on magnetic tape and cartridge standards incompatible with the CARTRIVISION system, the Company could be at a competitive marketing disadvantage.

Production

The Company has entered into agreements with two divisions of Avco providing for the production of 25,000 CARTRIVISION recorder-playback units in the presently agreed configuration, and for an option to purchase up to an additional 175,000 units. Using capital equipment and tooling owned and supplied by the Company, Avco's Electronics Division will produce electronic and mechanical components of the system at Huntsville, Alabama, and its Precision Products Division will manufacture and assemble the CARTRIVISION recorder-playback units at Richmond, Indiana. The Company has agreed to reimburse Avco for certain startup expenses aggregating approximately $1,567,000 incurred and to be incurred for the Company's account.

The agreements with Avco specify unit target costs and prices (including an 8% profit) based on delivery of a total of 200,000 units. If the Company does not exercise its option to acquire this entire quantity in accordance with the agreed delivery schedule, additional charges (estimated at a maximum of $2,900,000 if the Company does not exercise any part of its option) may be made by Avco based on its incurred costs, and equitable adjustments will be made in the target costs and prices based on any changes in the presently agreed configuration. On completion of delivery of 200,000 units, Avco's actual costs will be reviewed and cost savings or overruns from the agreed

target cost will be shared equally by the Company and Avco, provided that the final price cannot exceed 116% of the adjusted target cost.

The Company does not intend to establish its own facilities for manufacturing the CARTRIVISION system, but expects to contract with various domestic and foreign television receiver manufacturers to produce and market for their own account CARTRIVISION units on a nominal royalty or royalty-free basis. The Company has granted Admiral Corporation a five-year non-exclusive royalty-free license (renewable on certain conditions) permitting Admiral to manufacture and sell CARTRIVISION recorder-playback units.

The cartridge producing facility which the Company is equipping at San Jose, California, is expected to have the capability of producing more than 200,000 blank and pre-recorded CARTRIVISION cartridges per month when fully operating on a single shift basis. If sufficient demand for its cartridges develops, the Company may establish additional cartridge manufacturing facilities or license other manufacturers to produce cartridges under the CARTRIVISION name on a royalty basis.

The Company recognizes the importance of quality control and continuous supply of video heads for its CARTRIVISION system, and has been conducting video head preoperating work with the intent of creating an internal source of supply. Prototype video heads are currently being produced at the San Jose facility, and the Company plans to install additional equipment at that location to enable it to establish a video head production capability. The Company also plans to purchase video heads from other sources.

Several sources of magnetic video tape are presently available to the Company, and the plastic material used in fabricating cartridges is available from a number of suppliers.

Marketing

Marketing plans for the CARTRIVISION system have not yet been finally determined. Initially, the Company will depend on sales of its system components to television receiver manufacturers who will market, for their own account, the completed CARTRIVISION system to consumers through distributors and retailers. Admiral Corporation has agreed to purchase from the Company 10,000 recorder-playback units (with an option to purchase an additional 10,000 units), integrate the units with its own television receivers, and sell the completed CARTRIVISION systems (see Production above). In addition, Warwick Electronics Inc., a corporation associated with Sears, Roebuck and Co., has placed an order with the Company for 3,001 recorder-playback units to be delivered commencing in mid-1972 to cover the introduction of the CARTRIVISION system by Sears. The Company also intends to market, for its own account, CARTRIVISION units to commercial, industrial and governmental customers.

The Company estimates that the retail price of the CARTRIVISION system, including the color television receiver, will be approximately $900-$1,000, although the Company may have no control over the price of certain elements of the system such as the receiver. The CARTRIVISION cartridges are expected to be offered for retail sale at prices ranging from approximately $10 to approximately $40, depending upon length (in the case of blank cartridges) and length, content and artist (in the case of pre-recorded cartridges). Distribution of cartridges is expected to be made initially through CARTRIVISION system dealers and selected music, record and audio cassette/cartridge distributors. Pre-recorded cartridges will also be offered for rent at rentals starting at approximately $3 per use, and are expected to be available through a variety of retail outlets.

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Arrangements have been made with United Artists Corporation and Time-Life Video, a division of Time Incorporated, giving each company the right to purchase CARTRIVISION cartridges containing programming supplied by them at specified wholesale prices. The agreement with Time-Life Video also provides for certain mutual promotional efforts on a non-exclusive basis. No other arrangements have yet been made for distribution of the CARTRIVISION cartridges.

Programming

Although blank cartridges will be offered for use in recording television programs off the air, or for making "home movies" with an auxiliary camera, much of the market appeal of home video systems is expected to revolve around the availability of pre-recorded cartridges offering a broad range of subject matter. Accordingly, the Company is actively engaged in negotiating agreements making available to it movies, sporting events, musical and educational programs, "how-to" instruction, travel subjects, documentaries, cartoons, and dance and poetry performances for distribution on CARTRIVISION cartridges.

The Company has acquired non-exclusive license rights to more than 800 film presentations. These include 95 feature films from Avco Embassy Pictures Corp. (a subsidiary of Avco), 50 from United Artists Corporation, 28 from Lion International Films and 15 from American International Pictures, Inc. Rights have also been negotiated for the use of National Football League films, a film series of well-known prize fights, instructional films dealing with a variety of participatory sports and filmed classical music productions.

Substantially all of the Company's initial programming will consist of previously exhibited subject matter. The Company is seeking to obtain rights to original musical programs, including full-length symphonies, rock and pop concerts, country and western music, and opera and ballet productions. In this connection, the Company may participate in some production financing, but most of its programming is expected to be acquired from outside sources without Company participation.

The programming license agreements which are being negotiated give the Company the right to distribute the subject matter on CARTRIVISION cartridges for a specified period (normally at least three years) in return for royalties based upon the receipts derived by the Company from the sale or rental of the cartridges. Renewal rights for varying periods of time are customarily included, and minimum royalty guarantees are sometimes required. (See Note 4(a) to Financial Statements.)

Keen competition is developing for home video programming rights, but since most of the subjects are being made available to potential competitors on a non-exclusive basis, the Company does not anticipate any major problems in securing rights to a broad range of material.

Patents and Trademarks

The Company has filed a number of United States and foreign patent applications in order to seek patent protection for various inventions incorporated in the CARTRIVISION system, and it plans to file additional domestic and foreign patent applications in the future. The present applications are directed to the cartridge and certain features of the recorder-playback unit, including the cartridge carriage, the tape guides, the spindle by which the tape is driven, and various other mechanical and electrical features of the system.

The patentability of these inventions has generally not yet been determined, but the Company's patent counsel, Messrs. Townsend and Townsend of San Francisco, California, believe that the prospects of obtaining patent protection for certain features of the recorder-playback unit and cartridge are good. The Company believes that its inventions, patent applications and proprietary data will

discourage unlicensed copying or slavish imitation of its system. There can, however, be no assurance that patents will issue on the Company's patent applications or on any application it files in the future or that patents issued to the Company will be enforceable, if litigated, nor does the Company believe that it has established a unique proprietary position.

Messrs. Townsend and Townsend do not know of any clearly valid adversary United States patents which can successfully be asserted against the Company's presently proposed recorder-playback unit and cartridge, although the prior art in the field discloses a number of patents which relate in varying degrees to the CARTRIVISION system and adversary claims could be made at any time by competitors of the Company.

A United States patent relating to a type of frequency modulation recording has been called to the Company's attention by a substantial United States patent owner in view of the proposed use of frequency modulation recording in the CARTRIVISION system. The validity of this patent has never been adjudicated.

A number of United States, European and Japanese manufacturers are owners of issued patents and patent applications directed to band width reduction systems which have become involved in multiple patent interference proceedings in the United States Patent Office, and there are similar proceedings in Japan. While the Company is not involved in any of these proceedings, it may ultimately be required to negotiate license terms with the prevailing parties with respect to these patents.

The Company may decide to use a type of duplicating process in producing pre-recorded CARTRIVISION cartridges which may involve another company's United States patent expiring early in 1973.

The Company believes that, if necessary, reasonable patent license agreements can be negotiated with each of the foregoing patent owners, but no assurance to this effect can be given. Failure to obtain any necessary licenses at a reasonable cost might have an adverse effect on the results of operations of the Company.

The Company has registered the trademark "CARTRIVISION" in the United States and in eleven foreign countries, and applications for registration of this mark are pending in other foreign countries.

Plants and Properties

The Company's principal executive offices at 1115 Broadway, New York, New York, occupy approximately 9,000 square feet of office space sublet from Playtape. (See Background above and MANAGEMENT — Directors and Officers below for further information concerning this and certain other relationships between the Company and its management and Playtape.)

In January 1970, the Company acquired a building having 128,000 square feet on eleven acres in San Jose, California. This building has been renovated and is being converted into a cartridge and video head manufacturing facility, with warehouse space and an engineering laboratory. Construction of a 16,200 square foot building adjacent to the plant for administration and engineering offices was recently completed. This property is subject to a deed of trust securing payment of the balance of its purchase price over the period ending January 1, 1975. (See Statement of Liabilities in Financial Statements.)

The Company does not at present intend to acquire or construct any other manufacturing or office space, except possibly for additional cartridge producing plants if consumer demand for CARTRIVISION cartridges makes such expansion desirable.

Employees

As of May 31, 1971, the Company had 136 full-time employees, of whom 59 were principally engaged in technical operations, 33 in production, programming and marketing activities and 44

in administrative and clerical operations. Qualified persons having the technical and electronic capabilities required for the continued development of the Company's Cartrivision system are in short supply, and failure by the Company to retain its present key technical personnel or to attract additional personnel could have an adverse effect on its operations. The Company believes that its relations with its employees are satisfactory.

MANAGEMENT

Directors and Officers

The directors and executive officers of the Company are as follows:

Name and address	Position	Principal occupation
James R. Kerr 1275 King Street Greenwich, Connecticut	Chairman of the Board of Directors	President and Chief Executive Officer, Avco Corporation
Frank Stanton 1115 Broadway New York, New York	President and Director	President, Cartridge Television Inc.
Charles D. Brown 1080 North Seventh Avenue San Jose, California	Vice President and General Manager, West Coast Operations	Vice President, Cartridge Television Inc.
Samuel W. Gelfman 1115 Broadway New York, New York	Vice President, Production and Programming	Vice President, Cartridge Television Inc.
Donald F. Johnston 1080 North Seventh Avenue San Jose, California	Vice President, Marketing	Vice President, Cartridge Television Inc.
Denis B. Trelewicz 1115 Broadway New York, New York	Vice President, Treasurer and Secretary	Vice President, Cartridge Television Inc.
Ernest S. Alson Greenbush Road Orangeburg, New York	Director	Vice President, World-Wide Volkswagen Corp.
Alan S. Berk 1275 King Street Greenwich, Connecticut	Director	Vice President and Controller, Avco Corporation
James R. Dempsey 201 Lowell Street Wilmington, Massachusetts	Director	Vice President and Group Executive, Avco Corporation
Victor Elmaleh 76-02 Northern Boulevard Jackson Heights, New York	Director	Chairman of the Board and President, Magna-Dolphin Inc., automobile distributor
Arthur Stanton Greenbush Road Orangeburg, New York	Director	Chairman of the Board and President, World-Wide Volkswagen Corp.
Gordon M. Tuttle 1275 King Street Greenwich, Connecticut	Director	Vice President and General Counsel, Avco Corporation

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Messrs. Alson, Elmaleh and Frank and Arthur Stanton were active in the founding and organizing of the Company and may be considered "founders" for purposes of the Securities Act of 1933. Messrs. Alson and Frank and Arthur Stanton have been senior officers of World-Wide Volkswagen Corp. for more than five years, and Mr. Elmaleh has been President of Magna-Dolphin Inc. since its formation in 1960. In addition, Messrs. Elmaleh and Frank Stanton have been senior officers of Cragstan Industries, Inc., a toy manufacturer, for more than five years. The Messrs. Stanton are brothers.

Mr. Berk held management positions, including Principal, with Arthur Young & Company, certified public accountants, for more than five years prior to becoming an Avco officer in December 1967. Messrs. Dempsey, Kerr and Tuttle have been senior officers of Avco for more than five years. Mr. Brown held management positions in the Electronics Division of Avco from September 1967 to December 1969, when he became Vice President of the Company. Prior to joining Avco, Mr. Brown was President of an electronics division of Textron Inc. for more than six years.

Mr. Gelfman was Vice President of the Motion Picture Department of General Artists Corporation from 1965 to September 1967 and Assistant to the President of United Artists Corporation from September 1967 until he joined the Company in March 1970. Mr. Johnston was a Vice President of Philco-Ford Corporation for more than five years before joining the Company in May 1970. Mr. Trelewicz held various staff positions with Avco from 1965 to June 1969, when he took a leave of absence to accept a Sloan Fellowship at the Massachusetts Institute of Technology. He joined the Company in June 1970.

Messrs. Alson, Elmaleh and Frank and Arthur Stanton are officers and directors of Playtape and own 92.1% of the outstanding common stock of World-Wide Volkswagen Corp., of which Playtape is a wholly-owned subsidiary. Reference is made to HISTORY AND BUSINESS — Background above for information concerning the acquisition by the Company from Playtape of certain rights in its home video tape recorder-playback system. The Company's principal executive offices, and the furniture and equipment located therein, are sublet pursuant to an agreement with Playtape expiring December 31, 1972 which provides for an annual rental of $42,000.

Thor W. Kolle, Jr., a General Partner of Hornblower & Weeks-Hemphill, Noyes, David L. Coffin, President of The Dexter Corporation, a producer of specialty chemicals and specialized long-fibre products, and George S. Trimble, President of The Bunker-Ramo Corporation, a diversified manufacturer and supplier of electronic components, information systems and services and other products, are expected to be elected directors of the Company shortly after completion of this offering. Each such person has consented to serve if elected.

Remuneration of Officers and Directors

The following table shows the annual remuneration being paid by the Company (*i*) to each director and each of the three highest paid officers of the Company whose annual remuneration exceeds $20,000 and (*ii*) to all officers and directors of the Company as a group:

Name	Capacity in which remuneration is being received	Aggregate annual remuneration
Frank Stanton	President	$ 75,000
Donald F. Johnston	Vice President	65,000
Samuel W. Gelfman	Vice President	50,000
All 12 officers and directors as a group		265,000

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Since most officers have not been employed full-time by the Company for a complete fiscal year, the remuneration shown above is the annual salary which each officer is now receiving. Mr. Johnston is presently employed pursuant to an employment agreement expiring on May 10, 1972.

Stock Option Plan

The Company has adopted a Stock Option Plan, pursuant to which options to purchase a maximum of 175,000 authorized but unissued or treasury shares of the Company's common stock may be granted to officers (including officers who are directors) and other key employees of the Company. Options granted under the Plan, which is administered by the Board of Directors, may at the Board's discretion be either stock options "qualified" under Section 422 of the Internal Revenue Code or unqualified stock options.

All qualified options will be exercisable in cumulative installments over a five-year period at an option price equal to the fair market value of the Company's common stock on the date of grant. Unqualified options may have such terms as may be designated by the Board. Options may be exercised only by the optionee while he is employed by the Company (with certain limited exceptions for death or termination without cause), and they may not be transferred otherwise than by will or by operation of the laws of descent and distribution.

The Company's Board of Directors has approved the grant of qualified options to acquire an aggregate of 41,500 common shares at the Price to Public, effective as of the date of this Prospectus, including 2,500 shares each to Messrs. Johnston and Gelfman and 10,000 shares to all officers and directors of the Company as a group. The directors have also approved the grant to Frank Stanton of an option to acquire 50,000 common shares on similar terms. This option cannot be qualified due to the number of common shares owned by Mr. Stanton.

Certain Transactions

In connection with its original organization, the Company sold in 1968 an aggregate of 218,100 shares (giving effect to the merger described below) of its common stock for an aggregate purchase price of $7,270 ($.03 per share) to the following officers and directors: Ernest S. Alson, 15,600 shares; Victor Elmaleh, 67,500 shares; Arthur Stanton, 67,500 shares; and Frank Stanton, 67,500 shares. See Directors and Officers above for information concerning the relationships with Playtape of these officers and directors.

Shortly before the date of this Prospectus, the Company's New York predecessor corporation was merged into the Company, and each of the predecessor's previously outstanding common shares was changed into 300 common shares of the Company, leaving 627,750 common shares then outstanding. Avco then exchanged $7,100,000 principal amount of the Company's outstanding indebtedness held by Avco (see HISTORY AND BUSINESS — Background above) for 355,000 newly issued common shares of the Company and 10-year common stock purchase warrants evidencing the right to purchase 12,500 shares of the Company's common stock at the Price to Public. The following table sets forth the percentage of ownership of the Company's common shares before and after the foregoing refinancing, after this public offering, and after all common stock purchase warrants of the Company have been exercised:

	Before refinancing	After refinancing	After offering	After exercise*
Avco Corporation	50.2%	68.2%	32.2%	31.8%
Other present stockholders	49.8	31.8	15.0	14.6
Public	—	—	52.8	51.3
Hornblower & Weeks-Hemphill, Noyes	—	—	—	2.3

* Assumes 100% exercise by the recipients of the warrants being received by Avco (see above) and by Hornblower & Weeks-Hemphill, Noyes (see UNDERWRITING below).

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All officers and directors of the Company as a group own beneficially and of record 214,500 shares of the Company's common stock, representing 21.8% of its outstanding common shares. Upon completion of this public offering, all officers and directors as a group will own 10.3% of the Company's outstanding common shares. As of May 31, 1971, the Company's officers and directors as a group beneficially owned 1,251 shares (.01%) of Avco's outstanding common stock and 15,599 shares (.3%) of its outstanding $3.20 cumulative convertible preferred stock.

Reference is made to HISTORY AND BUSINESS — Background for information concerning Avco's majority stock ownership of the Company, Avco's designation of four of the Company's eight directors and Avco's position as the principal lender to the Company, at the time of negotiation of the refinancing described above and the contractual arrangements described in HISTORY AND BUSINESS — Production above.

DESCRIPTION OF COMMON STOCK AND WARRANTS

The Company's common stock ($1 par value) carries non-cumulative voting rights of one vote per share. Common shares have no preemptive, subscription or conversion rights and are not subject to redemption. All of the outstanding shares of common stock are, and all of the common shares offered hereby (when issued and paid for) will be, validly issued, fully paid and non-assessable.

The holders of common stock are entitled to receive such dividends as may be declared by the Company's Board of Directors out of earnings lawfully available therefor. In the event of any liquidation of the Company, the holders of common stock have the right to receive all assets available for distribution after settlement of prior claims, in accordance with their respective holdings. For the purpose of qualifying the shares offered hereby for sale under the securities laws of several states, certain of the Company's present stockholders have agreed not to participate in any distribution of assets in the event of the Company's liquidation and/or in any dividends paid by the Company until the Company has achieved certain levels of earnings or until such restrictions are released by the applicable state securities commissions. In addition, substantially all of the Company's present stockholders have agreed not to dispose of any common shares for a period of 90 days after the date of this Prospectus without the prior written consent of Hornblower & Weeks-Hemphill Noyes.

The transfer agent and registrar for the Company's common stock is Manufacturers Hanover Trust Company, New York, New York, and Crocker National Bank acts as co-transfer agent and co-registrar in Los Angeles, California.

The Company intends to furnish its stockholders with annual reports containing financial statements certified by independent certified public accountants, as well as such interim and other reports as its Board of Directors may deem appropriate.

Each 10-year common stock purchase warrant presently held by Avco permits the holder to purchase one share of the Company's common stock at any time within ten years after the date of this Prospectus at the Price to Public. The exercise price of these warrants is subject to appropriate adjustment to protect against dilution.

The terms of the Company's 5-year common stock purchase warrants to be issued to Hornblower & Weeks-Hemphill, Noyes are described under UNDERWRITING below.

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UNDERWRITING

The Underwriters named below, for whom Hornblower & Weeks-Hemphill, Noyes is the Representative, have severally agreed, subject to the terms and conditions in the Underwriting Agreement, to purchase from the Company the number of shares of common stock set forth below:

Underwriter	Address	Number of Shares to be Purchased
Hornblower & Weeks-Hemphill, Noyes	8 Hanover Street, New York, New York 10004	390,000
Lehman Brothers Incorporated	One William Street, New York, New York 10004	25,000
Bache & Co. Incorporated	100 Gold Street, New York, New York 10038	25,000
Bear, Stearns & Co.	One Wall Street, New York, New York 10005	12,000
Dominick & Dominick, Incorporated	14 Wall Street, New York, New York 10005	12,000
Equitable Securities, Morton & Co. Incorporated	65 Broadway, New York, New York 10005	12,000
Hallgarten & Co.	44 Wall Street, New York, New York 10005	12,000
Harris, Upham & Co. Incorporated	120 Broadway, New York, New York 10005	12,000
W. E. Hutton & Co.	14 Wall Street, New York, New York 10005	12,000
F. S. Moseley & Co.	60 Broad Street, New York, New York 10004	12,000
R. W. Pressprich & Co. Incorporated	80 Pine Street, New York, New York 10005	12,000
Shearson, Hammill & Co. Incorporated	14 Wall Street, New York, New York 10005	12,000
Shields & Company Incorporated	44 Wall Street, New York, New York 10005	12,000
G. H. Walker & Co. Incorporated	45 Wall Street, New York, New York 10005	12,000
Bateman Eichler, Hill Richards Incorporated	460 South Spring Street, Los Angeles, California 90013	10,000
Estabrook & Co., Inc.	80 Pine Street, New York, New York 10005	10,000
Fahnestock & Co.	110 Wall Street, New York, New York 10005	10,000
Faulkner, Dawkins & Sullivan Securities Inc.	One New York Plaza, New York, New York 10004	10,000
Hardy & Co.	25 Broad Street, New York, New York 10004	10,000
H. Hentz & Co. Inc.	72 Wall Street, New York, New York 10005	10,000
Jefferies & Company, Inc.	445 South Figueroa Street, Los Angeles, California 90017	10,000
Laidlaw & Co. Incorporated	25 Broad Street, New York, New York 10004	10,000
Newburger, Loeb & Co., Inc.	5 Hanover Square, New York, New York 10004	10,000
Oppenheimer & Co.	One New York Plaza, New York, New York 10004	10,000
Thomson & McKinnon Auchincloss Inc.	2 Broadway, New York, New York 10004	10,000
C. E. Unterberg, Towbin Co.	61 Broadway, New York, New York 10006	10,000
Bacon, Whipple & Co.	135 South La Salle Street, Chicago, Illinois 60603	7,000
George D. B. Bonbright & Co.	One West Main Street, Rochester, New York 14614	7,000
J. C. Bradford & Co., Incorporated	J. C. Bradford Building, Nashville, Tennessee 37219	7,000
Butcher & Sherrerd	1500 Walnut Street, Philadelphia, Pennsylvania 19102	7,000

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Underwriter	Address	Number of Shares to be Purchased
The Chicago Corporation	208 South La Salle Street, Chicago, Illinois 60604	7,000
Edwards & Hanly	1 Whitehall Street, New York, New York 10004	7,000
Eppler, Guerin & Turner, Inc.	3900 First National Bank Building, Dallas, Texas 75202	7,000
First of Michigan Corporation	2 Wall Street, New York, New York 10005	7,000
Fulton, Reid & Staples, Inc.	2100 East Ohio Building, Cleveland, Ohio 44114	7,000
Hayden, Miller Division of Stone & Webster Securities Corporation	Union Commerce Building, Cleveland, Ohio 44115	7,000
Interstate Securities Corporation	221 South Tryon Street, Charlotte, North Carolina 28202	7,000
Kohlmeyer & Co.	147 Carondelet Street, New Orleans, Louisiana 70130	7,000
Laird Incorporated	140 Broadway, New York, New York 10005	7,000
Legg, Mason & Co., Inc.	22 Light Street, Baltimore, Maryland 21203	7,000
Loewi & Co. Incorporated	225 East Mason Street, Milwaukee, Wisconsin 53202	7,000
McDonald & Company	2100 Central National Bank Building, Cleveland, Ohio 44114	7,000
The Milwaukee Company	207 East Michigan Street, Milwaukee, Wisconsin 53202	7,000
Mitchell, Hutchins & Co. Incorporated	One Battery Park Plaza, New York, New York 10004	7,000
Mitchum, Jones & Templeton Incorporated	510 South Spring Street, Los Angeles, California 90013	7,000
Moore, Leonard & Lynch, Incorporated	1003 Union Trust Building, Pittsburgh, Pennsylvania 15219	7,000
Moore & Schley, Cameron & Co.	2 Broadway, New York, New York 10004	7,000
Newhard, Cook & Co.	400 Olive Street, St. Louis, Missouri 63102	7,000
H. O. Peet & Co. Inc.	23 West 10th Street, Kansas City, Missouri 64105	7,000
Piper, Jaffray & Hopwood Incorporated	115 South Seventh Street, Minneapolis, Minnesota 55402	7,000
Putnam, Coffin, Doolittle, Newburger Division of Advest Co.	115 Broadway, New York, New York 10006	7,000
Rauscher Pierce Securities Corporation	1200 Mercantile Dallas Building, Dallas, Texas 75201	7,000
Reinholdt & Gardner	506 Olive Street, St. Louis, Missouri 63101	7,000
L. M. Rosenthal & Company, Inc.	5 Hanover Square, New York, New York 10004	7,000
Sutro & Co. Incorporated	460 Montgomery Street, San Francisco, California 94104	7,000
Underwood, Neuhaus & Co. Incorporated	724 Travis, Houston, Texas 77002	7,000
Watling, Lerchen & Co.	Ford Building, Detroit, Michigan 48226	7,000
Weis, Voisin & Co., Inc.	17 Battery Place North, New York, New York 10004	7,000
Wheat & Co., Inc.	801 East Main Street, Richmond, Virginia 23211	7,000
Wood, Walker & Co.	63 Wall Street, New York, New York 10005	7,000
Adams & Peck	120 Broadway, New York, New York 10005	6,000
Almstedt Brothers	425 West Market Street, Louisville, Kentucky 40202	6,000
Birr, Wilson & Co., Inc.	155 Sansome Street, San Francisco, California 94104	6,000
D. H. Blair & Company	437 Madison Avenue, New York, New York 10022	6,000
B. C. Christopher & Company	4800 Main Street, Kansas City, Missouri 64112	6,000
Cowen & Co.	1 Battery Park Plaza, New York, New York 10004	6,000
Craigie Incorporated	616 East Main Street, Richmond, Virginia 23215	6,000
R. G. Dickinson & Co.	910 Grand Avenue, Des Moines, Iowa 50309	6,000

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Underwriter	Address	Number of Shares to be Purchased
Elkins, Morris, Stroud & Co.	Stock Exchange Building, 17th and Sansom Streets, Philadelphia, Pennsylvania 19103	6,000
First Mid America Corporation	1001 "O" Street, Lincoln, Nebraska 68501	6,000
W. D. Gradison & Co.	408 Dixie Terminal Building, Cincinnati, Ohio 45202	6,000
Hallowell, Sulzberger, Jenks & Co.	Philadelphia National Bank Building, Broad and Chestnut Streets, Philadelphia, Pennsylvania 19107	6,000
Havenfield Corporation	120 Broadway, New York, New York 10005	6,000
Lentz, Newton & Co.	Alamo National Building, San Antonio, Texas 78205	6,000
The Marshall Company, Inc.	111 East Wisconsin Avenue, Milwaukee, Wisconsin 53202	6,000
Parker/Hunter Incorporated	1146 Union Trust Building, Pittsburgh, Pennsylvania 15219	6,000
Pressman Frohlich & Frost Incorporated	140 Broadway, New York, New York 10005	6,000
Roberts, Scott & Co., Inc.	First National Bank Building, San Diego, California 92112	6,000
Russ & Company Incorporated	1600 Alamo National Building, San Antonio, Texas 78205	6,000
Schneider, Bernet & Hickman Securities Corporation	3200 First National Bank Building, Dallas, Texas 75202	6,000
Seiden & de Cuevas Incorporated	110 Wall Street, New York, New York 10005	6,000
Stix & Co. Inc.	319 North Fourth Street, St. Louis, Missouri 63102	6,000
Henry F. Swift & Co.	510 Montgomery Street, San Francisco, California 94111	6,000
Burton J. Vincent & Co.	105 West Adams Street, Chicago, Illinois 60603	6,000
Zuckerman, Smith & Co.	30 Broad Street, New York, New York 10004	6,000
Hartzmark & Co., Inc.	1000 East Ohio Building, Cleveland, Ohio 44114	4,000
Hill & Co.	1717 Provident Tower, Cincinnati, Ohio 45202	4,000
A. C. Kluger & Co.	200 East 42nd Street, New York, New York 10017	4,000
Manley, Bennett, McDonald & Co.	1100 Buhl Building, Detroit, Michigan 48226	4,000
Raffensperger, Hughes & Co., Inc.	20 North Meridian Street, Indianapolis, Indiana 46204	4,000
		1,100,000

The Underwriters have agreed to purchase all the shares offered hereby if they purchase any of the shares.

Hornblower & Weeks-Hemphill, Noyes, as Representative of the several Underwriters, has advised the Company that the Underwriters propose to offer the shares in part directly to the public at the Price to Public set forth on the cover page of this Prospectus and in part to certain dealers at such Price less a concession of $1.00 per share; and that the Underwriters may allow and such dealers may reallow on sales to certain other dealers a discount not exceeding $0.25 per share. The Price to Public and concession may be changed from time to time by the Representative.

The Company will issue to Hornblower & Weeks-Hemphill, Noyes without cost, as additional compensation, five-year warrants to purchase 50,000 shares of common stock at a price per share equal to 120% of the Price to Public. By their terms, the warrants expire five years after the date of this Prospectus and may not be exercised for a period of one year after the date of this Prospectus, nor may the warrants be transferred during their life except to and among partners of Hornblower &

Weeks-Hemphill, Noyes. The warrants provide for appropriate adjustment to protect against dilution. Hornblower & Weeks-Hemphill, Noyes will have certain rights with respect to the registration under the Securities Act of 1933 of the common shares purchased upon the exercise of the warrants. Any profits realized by Hornblower & Weeks-Hemphill, Noyes when the underlying shares are sold may be deemed additional underwriting compensation.

During the term of the warrants, Hornblower & Weeks-Hemphill, Noyes or its partners will have, at no cost, the opportunity to profit from a rise in the market for the Company's common shares, with a resulting dilution in the interest of the stockholders of the Company. Furthermore, the holders of the warrants might be expected to exercise ther at a time when the Company could obtain any needed capital by a new offering of securities on terms more favorable to the Company than those provided for by the warrants.

Thor W. Kolle, Jr., a General Partner of Hornblower & Weeks-Hemphill, Noyes, is expected to be elected a director of the Company shortly after completion of this offering. See MANAGEMENT — Directors and Officers above.

LEGAL OPINIONS

The legality of the securities being offered hereby is being passed upon for the Company by Messrs. Shea Gould Climenko & Kramer, 330 Madison Avenue, New York, New York 10017 and for the Underwriters by Messrs. Milbank, Tweed, Hadley & McCloy, 1 Chase Manhattan Plaza, New York, New York 10005.

EXPERTS

The statements under HISTORY AND BUSINESS — Patents and Trademarks above have been reviewed by Messrs. Townsend and Townsend, One Kearny Street, San Francisco, California 91408, as patent and trademark counsel for the Company, and are included in reliance upon the authority of such firm as experts.

The historical financial statements of the Company appearing in this Prospectus and the Registration Statement have been examined by Arthur Young & Company, independent certified public accountants, as set forth in their report appearing elsewhere herein, and are included in reliance upon such report and upon the authority of such firm as experts.

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Exhibit A Annexed to Affidavit of Laura Banfield

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Exhibit A Annexed to Affidavit of Laura Banfield

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors
Cartridge Television Inc.

We have examined the accompanying historical statements of assets, intangibles and deferrals, of liabilities and of capital shares of Cartridge Television Inc. (a company in the development stage — see Note 1) at March 31, 1971 and the related statement of cash receipts and disbursements for the period June 27, 1968 (date of incorporation) to November 30, 1968, the years ended November 30, 1969 and 1970, and the four months ended March 31, 1971. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note 1, the Company has incurred significant amounts of research and preoperating costs, which costs have been deferred. It is not possible at present to determine whether these costs ultimately will be recovered since recovery is dependent upon the success of future operations.

In our opinion, the statements mentioned above present fairly, on the basis of the applicable accounting requirements of the Securities and Exchange Commission, which constitutes an acceptable basis for presenting the accounts of the Company at this time, the historical cost of assets, intangibles and deferrals, the historical liabilities and the historical capital shares of Cartridge Television Inc. at March 31, 1971 and its cash transactions for the period June 27, 1968 (date of incorporation) to March 31, 1971, on a consistent basis during the period.

We have also reviewed the application of the pro forma adjustments described in Note 6 and, in our opinion, such pro forma adjustments have been properly applied on the basis described therein.

ARTHUR YOUNG & COMPANY

San Jose, California
July 12, 1971

Exhibit A Annexed to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

STATEMENT OF ASSETS, INTANGIBLES AND DEFERRALS (Notes 1 and 3)
March 31, 1971

	Historical	Pro forma unaudited (Note 6)
Current assets:		
Cash	$ 38,522	$ 38,522
Advances and prepaid expenses	37,444	37,444
Total current assets	75,966	75,966
Additional loan commitment from Avco Corporation (Note 6)	—	1,050,000
Property, plant and equipment, at cost (Note 2)	2,373,782	2,373,782
Accumulated depreciation	(184,186)	(184,186)
Net property, plant and equipment	2,189,596	2,189,596
Intangibles and deferrals:		
Patent applications, at cost	60,521	60,521
Research and preoperating costs (Note 1)	6,075,700	6,075,700
	$8,401,783	$9,451,783

STATEMENT OF LIABILITIES
March 31, 1971

Current liabilities:		
Notes payable to Avco Corporation (Note 3)	$5,450,000	$ 400,000
Trade accounts payable, including $440,232 payable to Avco Corporation	539,740	539,740
Accrued interest payable to Avco Corporation (Note 3)	222,572	311,074
Accrued payroll and payroll taxes	58,894	58,894
Other accrued liabilities	33,275	33,275
Long-term debt due within one year	130,200	130,200
Total current liabilities	6,434,681	1,473,183
Notes and accrued interest payable to Avco Corporation (Note 3)	1,088,502	—
8½% note payable (secured by deed of trust on land and buildings), due $10,850 monthly until the last payment of $10,050 on January 1, 1975, less $130,200 due within one year	368,100	368,100
Commitments and contingencies (Note 4)	—	—
	$7,891,283	$1,841,283

STATEMENT OF CAPITAL SHARES
March 31, 1971

	Number of shares	
	Historical	Pro forma unaudited (Note 6)
Common stock:		
Authorized	2,100(no par)	2,500,000($1 par)
Issued and outstanding:		
For cash ($525,000, less expenses of $15,000)	2,082½	624,750
For debt held by Avco Corporation (Note 6)	—	355,000
For property (valued at $500)	10	3,000
	2,092½	982,750
Reserved for options and warrants (Note 6)	—	237,500

See accompanying notes.

Exhibit A Annexed to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

STATEMENT OF CASH RECEIPTS AND DISBURSEMENTS

	June 27, 1968 (date of incorporation) to November 30, 1968	Year ended November 30, 1969	Year ended November 30, 1970	Four months ended March 31, 1971	Total
Cash receipts:					
Sales of common stock	$ 10,000	$515,000			$ 525,000
Proceeds of loans from Avco Corporation (Note 3)		200,000	$4,900,000	$1,350,000	6,450,000
Total cash receipts	10,000	715,000	4,900,000	1,350,000	6,975,000
Disbursements (accrual basis):					
Research and preoperating costs (Notes 1 and 3):					
Salaries of officers and directors		15,000	162,369	79,416	256,785
Other salaries and employee benefits		256,556	1,414,233	625,312	2,296,101
Materials and supplies		29,990	573,384	147,471	750,845
Travel		112,712	111,905	34,265	258,882
Advertising, promotion and market surveys		47,316	189,100	18,340	254,756
Taxes		250	47,000	17,575	64,825
Rent and utilities		23,098	146,433	62,977	232,508
Industrial design		804	102,982	17,765	121,551
Engineering services and consulting fees		54,550	260,816	33,015	348,381
Interest (net of $9,673 interest income)		(1,554)	263,487	179,512	441,445
Employment expenses			133,521	9,545	143,066
Purchase of invention	120,000				120,000
Avco's production startup costs				(393,779)	393,779
Other		24,705	134,915	48,970	208,590
	120,000	563,427	3,540,145	1,667,942	5,891,514
Property, plant and equipment		63,029	2,300,815	9,938	2,373,782
Patent applications		31,098	23,604	5,819	60,521
Principal payments on 8½% note				151,700	151,700
Other		34,144	17,856	444	52,444
Total disbursements (accrual basis)	120,000	691,698	5,882,420	1,835,843	8,529,961
Accrual adjustments	115,000	214,734	781,060	482,689	1,593,483
Total cash disbursements	5,000	476,964	5,101,360	1,353,154	6,936,478
Net increase (decrease) in cash	5,000	238,036	(201,360)	(3,154)	38,522
Cash at beginning of period		5,000	243,036	41,676	
Cash at end of period	$ 5,000	$243,036	$ 41,676	$ 38,522	$ 38,522

See accompanying notes.

Exhibit A Annexed to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

NOTES TO FINANCIAL STATEMENTS
March 31, 1971

1. Basis of financial statements; research and preoperating costs

The Company is in the development stage. Its personnel are currently involved in the process of planning for the production and marketing of its recorder-playback units and cartridges and design and engineering of certain additional products related to the CARTRIVISION system; accordingly, all of its costs, which include $184,186 of depreciation, are being deferred. The Company estimates that approximately $24,474,817 (including $8,325,817 incurred through March 31, 1971) are required to develop its products and production techniques and to acquire property, plant and production equipment. The Company has no commitments or arrangements for financing its forecasted expenditures beyond July 14, 1971, other than the public offering of securities contemplated by this Prospectus. While management believes these costs will be fully recovered, the ultimate recovery of costs incurred or to be incurred is dependent upon future developments, including achievement of a level of operations which would permit such recovery. The eventual outcome of these matters cannot be determined at this time.

The Company intends to continue deferring all costs incurred until sales of its products commence. The Company plans to amortize research and preoperating costs applicable to each product by charges to earnings based on units expected to be sold, subject to increased amortization if sales exceed projections, during the 36 months beginning with the first sales of the respective products.

2. Property, plant and equipment

Property, plant and equipment, at cost, consists of:

Land	$ 282,638
Building	1,319,325
Machinery and equipment	237,449
Test and laboratory equipment	431,807
Furniture and fixtures	33,408
Leasehold improvements	69,155
	$2,373,782

Plant and equipment is depreciated ($5,252 and $100,574 in the years ended November 30, 1969 and 1970, respectively, and $78,360 in the four months ended March 31, 1971) as follows:

	Method	Life
Building	Straight-line	20 years
Machinery and equipment — production	Unit of production	6–10 years
Machinery and equipment — other	Straight-line	10 years
Test and laboratory equipment	Straight-line	6 years
Furniture and fixtures	Straight-line	8 years
Leasehold improvements	Straight-line	Term of the sub-lease

Exhibit A Annexed to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

NOTES TO FINANCIAL STATEMENTS – (Continued)

March 31, 1971

Maintenance and repairs have been charged to research and preoperating costs, and renewals and betterments are charged to property, plant and equipment. There have been no retirements or other disposals of property, plant or equipment.

3. Transactions with Avco Corporation

(a) *Notes payable*

The Company's activities have been financed principally by loans from Avco Corporation which owned 50.2% of the Company's outstanding common stock at March 31, 1971. The terms of the notes payable to Avco Corporation are as follows:

Notes payable due July 15, 1971, interest at 10% to January 31, 1971 and 9% thereafter	$4,050,000
Notes payable due November 30, 1971, interest at 2% above prime rate	1,400,000
	5,450,000
Subordinated notes payable due October 15, 1976 to March 2, 1977 and related accrued interest of $88,502, interest at prime rate accrued for first three years and payable in four subsequent annual installments	1,088,502
	$6,538,502

The Company has refinanced the above loans from Avco Corporation as described in Note 6 below. The $88,502 interest on the subordinated notes payable will become due and payable when proceeds are received from the public offering described in this Prospectus.

(b) *Other transactions*

Approximately $1,639,000 of research and preoperating costs (including interest of $385,000) have been charged to the Company by Avco Corporation. Once production begins, the Company intends to have certain products produced in Avco plants (the Company having agreed to reimburse Avco for production startup costs estimated to be approximately $1,567,000, of which $393,779 has been accrued representing costs incurred by Avco through March 31, 1971). In addition the Company will have substantial amounts of Company-owned capital equipment and tooling at these plants.

4. Commitments and contingencies

(a) The Company has entered into agreements with the owners of certain film properties for the purpose of licensing the Company to use such properties with its video tape cartridges. The agreements are for varying periods of time, none of which extends beyond 1976. The agreements call for royalties to be paid by the Company at varying rates, based on sales and rentals of the video tape cartridges. Certain of these agreements call for minimum royalty payments aggregating $275,000.

(b) The Company has entered into revised agreements with Playtape, Inc., an affiliated company (see HISTORY AND BUSINESS — Background and MANAGEMENT — Directors and Officers in this Prospectus), and Avco Corporation pursuant to which the Company will pay annual royalties to each company equal to the lesser of $500,000 or 2% of the income of the Company derived from the CAR-

Exhibit A Annexed to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

NOTES TO FINANCIAL STATEMENTS – (Continued)

March 31, 1971

television system before income taxes and these royalties (which royalties may be reduced as a result of certain patent and related contingencies) for each fiscal year in perpetuity commencing with the fiscal year beginning December 1, 1973.

(c) The Company is subleasing its New York executive offices from Playtape, Inc. for the period January 1, 1970 to December 31, 1972. The annual rental of $42,000 is intended to reimburse Playtape for its annual rental of $24,150 plus approximately 75% of the unrecovered cost as of January 1, 1970 of leasehold improvements made by Playtape.

(d) The Company has entered into an engineering services agreement with Barger Corporation which obligates the Company to pay royalties up to an aggregate maximum of $300,000 based on future sales of certain products.

5. Income tax

Research and preoperating costs which the Company has deferred for financial statement purposes (Note 1) are claimed as deductions for federal income tax purposes in the year incurred. As a result, the Company has an operating tax loss carryforward of approximately $690,000 relating to the year ended November 30, 1969, which expires in 1974. Research and preoperating costs of approximately $3,640,000 for the year ended November 30, 1970 and $1,746,000 for the four months ended March 31, 1971 also will be deducted for tax purposes, resulting in operating tax loss carryforwards which expire in 1975 and 1976, respectively. The Company's tax returns have not been examined by the Internal Revenue Service.

6. Change of incorporation; pro forma recapitalization and refinancing

The Company is a Delaware corporation having an authorized capitalization of 2,500,000 shares of $1 par value common stock. It was formerly an inactive wholly-owned subsidiary of a New York corporation having the same name and an authorized capitalization of 2,100 no par value common shares. On July 1, 1971, the New York parent was merged into the Company, and each of the outstanding common shares (no par value) of the predecessor corporation was changed and automatically converted into 300 common shares ($1 par value) of the Company's common stock.

A commitment by Avco Corporation as of March 31, 1971 to lend the Company an additional $1,050,000 (all of which has been received and substantially all of which has been used for research and preoperating costs and to purchase property, plant and equipment) has been reflected in the accompanying pro forma financial statements, as has the exchange by Avco on July 12, 1971 of $7,100,000 (including $650,000 of the foregoing $1,050,000) of the Company's then outstanding notes payable held by Avco for 355,000 shares of the Company's common stock and 10-year warrants exercisable at any time to purchase 12,500 shares of its common stock at the Price to Public set forth on the cover page of this Prospectus. See MANAGEMENT — Certain Transactions and DESCRIPTION OF COMMON STOCK AND WARRANTS in this Prospectus for further information concerning the foregoing refinancing and the terms of the warrants so issued by the Company.

Reference is made to MANAGEMENT — Stock Option Plan in this Prospectus for information concerning a stock option plan recently adopted by the Company.

Following the foregoing refinancing and the completion of the offering described in this Prospectus, an aggregate of 237,500 shares of the Company's common stock will be reserved for issuance as follows: 175,000 shares pursuant to the Company's stock option plan, 12,500 shares pursuant to exercise of the Company's 10-year warrants and 50,000 shares pursuant to exercise of the Company's 5-year warrants to be issued to Hornblower & Weeks-Hemphill, Noyes (see UNDERWRITING in this Prospectus).

Excerpt from Exhibit B to Affidavit of Laura Banfield

1971 Annual Report of Cartridge Television, Inc.

TO OUR SHAREHOLDERS

Dear Shareholders:

Thank you for joining us as charter members of a new company and a new industry.

Your company became publicly-owned in 1971, and during the year it substantially completed development work on the CARTRIVISION* video tape recorder-playback system pictured and described in this report. In addition, your management took the various manufacturing, merchandising and marketing steps necessary to permit consumer sales of CARTRIVISION* units in 1972.

Initial orders for CARTRIVISION* units were received during the year from Warwick Electronics Inc., a manufacturer of television sets for Sears, Roebuck and Co., Admiral Corporation, a television set manufacturer which also supplies sets to Montgomery Ward and National Union Electric Corporation, distributor of Emerson and DuMont equipment; and Teledyne Packard-Bell.

Rights were acquired to manufacture and distribute in the CARTRIVISION* video tape cartridge format more than 1,300 programming titles, representing a diversity of material ranging from cultural enrichment to cartoons and including more than 300 feature-length films.

Agreements were entered into with two divisions of Avco Corporation calling for the production of 25,000 CARTRIVISION* recorder-playback units, and your company has the option to purchase up to an additional 175,000 units.

Our engineering staff has developed high-speed printing facilities which will enable the company to duplicate a one-hour program on tape in two minutes.

During the year, marketing offices were opened in Palo Alto, California, the manufacturing facility at San Jose, California was equipped and expanded, and the company's management base was broadened through the addition of key personnel.

The proceeds from the company's successful public offering of 1,100,000 common shares in July are being applied to defray preoperating costs and startup expenses and to acquire equipment and tooling. In anticipation of the needs to be generated by future growth and expansion, your management is currently making plans to secure additional long and short-term financing for the company.

Various television set manufacturers are presently planning to introduce the CARTRIVISION* system commercially by mid-year and additional manufacturers are considering the adoption of our system.

We are confident that 1972 will be a year of rapid progress for the company, and have every hope that our CARTRIVISION* system will become recognized as a standard home video tape cartridge system in the United States.

James R. Kerr
JAMES R. KERR
Chairman of the Board

Frank Stanton
FRANK STANTON
President

March 1, 1972

Excerpt from Exhibit B to Affidavit of Laura Banfield

CARTRIDGE TELEVISION EMERGES

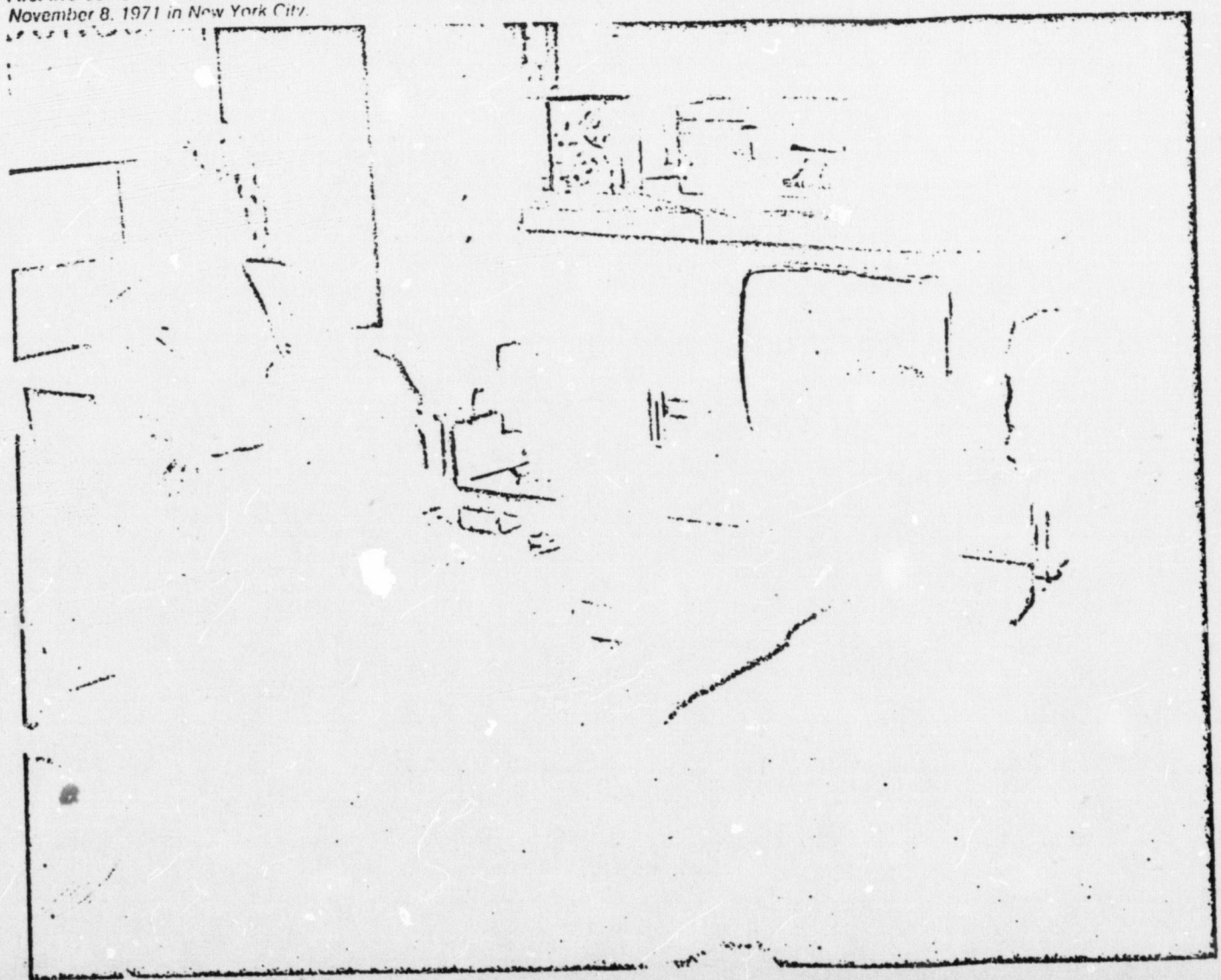
The past few years have seen the emergence of a growing demand for a medium that will allow viewers to see what they want to see, when they want to see it on a television screen.

Cartridge Television Inc. was formed to meet this demand. The company has developed and will market the CARTRIVISION® system which uses video tape cartridges to deliver entertainment and instructional information in color or black and white to home and industry through a television receiver.

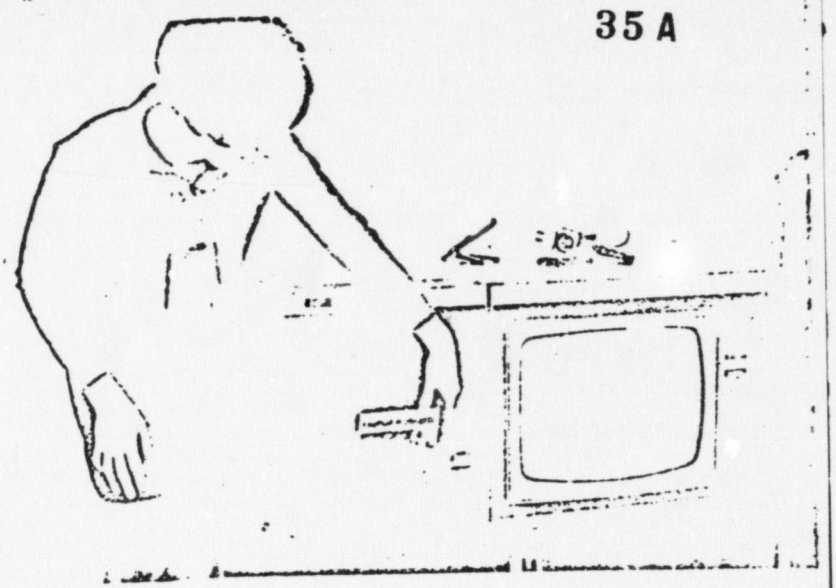
The system employs magnetic recording tape to provide the capability for playing pre-recorded programs of up to 114 minutes on a single tape cartridge. The system will also record television off the air, record "home movies" with sound on blank tape with a separate camera, receive conventional television broadcasts, and serve as a closed circuit video monitor.

Prototype units were demonstrated publicly for the first time at the Consumer Electronics Show in New York City in June, 1970. Industry reaction was enthusiastic. Now, after subsequent technological refinement, the CARTRIVISION® system is on the threshold of commercial introduction.

First live demonstrations of the CARTRIVISION color video tape cartridge system before the general public took place during the week of November 8, 1971 in New York City.

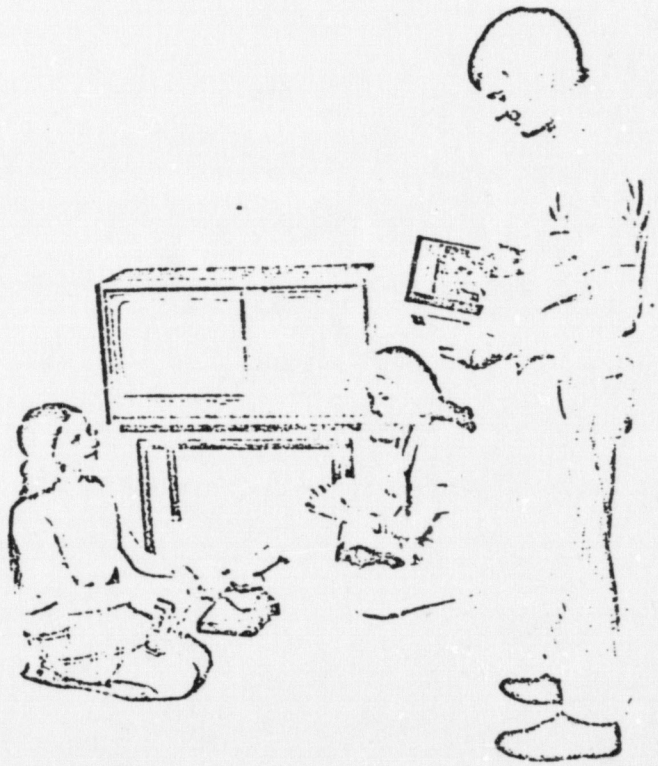


CARTRIVISION® SYSTEM COMPONENTS AND PROGRAMMING



The CARTRIVISION® system is expected to be introduced to the consumer market within the next few months. During 1971, prototype CARTRIVISION® tape decks and cartridges were delivered to a number of different U.S. television set manufacturers. Several of these manufacturers will market the complete system of equipment and programming under several different brand names, including those offered by Admiral, DuMont, Emerson, Montgomery Ward, Teledyne Packard-Bell and Sears, Roebuck.

The principal CARTRIVISION® component is a solid-state recorder-playback unit connected to a full-size color television receiver. Features of the system include unattended off the air automatic recording of television programs, as well as closed circuit television which permits the user to operate his camera while using the CARTRIVISION® set as a monitor.

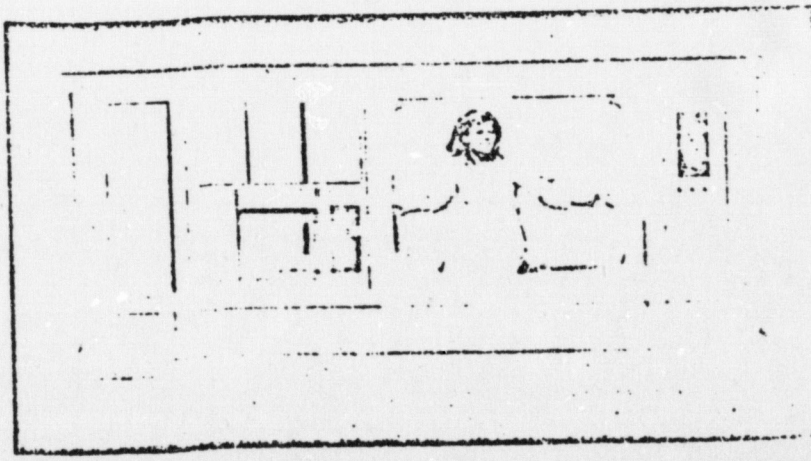


To provide the viewing public with a variety of programming, Cartridge Television Inc. has acquired rights to offer more than 1,300 cartridge titles in the fields of music, entertainment, sports and education. Educational and general instructional programming are equally represented with entertainment for viewers of all ages.

The company has entered into agreements covering more than 200 feature-length movies from the libraries of such film companies as United Artists, Avco Embassy Pictures, American International Pictures and Lion International Films.

Other programs signed for CARTRIVISION® distribution will cover many specific instructional, cultural, sports, musical and entertainment subjects, including cooking, golf, popular and classical music, science, cartoons and NFL football. Additional CARTRIVISION® titles will be available through Time-Life Video Service.

CARTRIVISION® cartridges will be available with pre-recorded programs in purchase and rental versions and with blank tape for home recording. Blank cartridges will come in two sizes: 15 to 30 minutes in length and 30 to 114 minutes in length.



CARTRIDGE TELEVISION INC.

STATEMENT OF ASSETS, INTANGIBLES AND DEFERRALS (Note 1)
November 30, 1971 and 1970

	1971	1970
Current assets		
Cash	$ 299,669	$ 41,676
Certificates of deposit and accrued interest receivable	14,027,407	—
Advances and prepaid expenses	375,449	37,000
Total current assets	14,702,525	78,676
Property, plant and equipment, at cost (Note 2)		
Land	289,681	282,638
Building and improvements	1,381,473	1,384,471
Machinery, test and laboratory equipment	1,149,601	652,758
Furniture and fixtures	58,497	28,878
	2,879,252	2,348,745
Accumulated depreciation	363,067	105,827
	2,516,185	2,242,918
Production facilities and equipment (including $1,265,305 in 1971 of construction in progress)	1,633,030	15,100
Net property, plant and equipment	4,149,215	2,258,018
Intangibles and deferrals:		
Patent applications, at cost	87,943	54,702
Research and preoperating costs (Notes 1 and 3)	10,434,448	4,329,398
	$29,374,131	$6,720,794

STATEMENT OF LIABILITIES
November 30, 1971 and 1970

	1971	1970
Current liabilities:		
Notes payable to Avco Corporation (Note 3)	$ —	$4,100,000
Accounts payable — Avco Corporation	401,548	28,668
Trade accounts payable	912,638	125,902
Accrued liabilities	207,551	236,065
Long-term debt due within one year	130,200	238,500
Total current liabilities	1,651,937	4,729,135
Long-term debt due after one year:		
Notes and accrued interest payable to Avco Corporation (Note 3)	—	1,069,659
8½% note payable, secured by deed of trust on land and buildings, due $130,000 on January 1, 1971 and $10,850 monthly thereafter until January 1, 1975	281,300	411,500
Commitments and contingencies (Notes 3 and 4)		
	$ 1,933,237	$ 6,210,294

STATEMENT OF COMMON STOCK AND ADDITIONAL PAID-IN CAPITAL
November 30, 1971 and 1970

Common stock, $1 par value; 2,500,000 shares authorized, 2,082,750 and 627,750 shares issued and outstanding in 1971 and 1970, respectively (Notes 6 and 7)	$ 2,082,750	$ 510,500
Additional paid-in capital	25,358,144	—
	$27,440,894	$ 510,500

See accompanying notes.

CARTRIDGE TELEVISION INC.

STATEMENT OF CASH RECEIPTS AND DISBURSEMENTS

For the years ended November 30, 1971 and 1970

	1971	1970
Receipts:		
Sales of common stock, net of expenses of $189,606	$19,830,394	$ —
Interest (including $177,407 accrued in 1971)	325,233	9,673
Proceeds of loans from Avco Corporation (Note 3)	2,500,000	4,900,000
Total receipts	22,655,627	4,909,673
Disbursements (accrual basis):		
Research and preoperating costs (Notes 1 and 3):		
Salaries and employee benefits	2,318,778	1,576,602
Materials and supplies	1,153,921	573,384
Interest	371,441	273,160
Avco's production startup costs	1,242,852	—
Other	1,085,956	1,126,672
	6,172,948	3,549,818
Property, plant and equipment	2,148,438	2,300,815
Patent applications	33,241	23,604
Principal payments on 8½% note	238,500	—
Payment of Avco Corporation loan (Note 3)	500,000	—
Other	338,449	17,856
Total disbursements (accrual basis)	9,431,576	5,892,093
Accrual adjustments	1,061,349	781,060
Total cash disbursements	8,370,227	5,111,033
Net increase (decrease) in cash, certificates of deposit and accrued interest	14,285,400	(201,360)
Cash at beginning of period	41,676	243,036
Cash, certificates of deposit and accrued interest at end of period	$14,327,076	$ 41,676

STATEMENT OF CHANGES IN COMMON STOCK AND ADDITIONAL PAID-IN CAPITAL

For the years ended November 30, 1971 and 1970

	Common Stock		Additional Paid-in Capital	Total
	Number of Shares	Amount		
Balance November 30, 1969 and 1970	2,092½	$ 510,500	$ —	$ 510,500
Adjustment to effect reincorporation of Cartridge Television Inc. (Note 6)	625,657½	117,250	(117,250)	—
Balance after adjustment	627,750	627,750	(117,250)	510,500
Issuances of stock:				
For debt held by Avco Corporation (Note 3)	355,000	355,000	6,745,000	7,100,000
Public offering, net of expenses of $189,606	1,100,000	1,100,000	18,730,394	19,830,394
Balance November 30, 1971	2,082,750	$2,082,750	$25,358,144	$27,440,894

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

November 30, 1971

1. Basis of financial statements; research and preoperating costs

The Company is in the development stage; accordingly, all of its costs, which include $363,067 of depreciation, are being deferred. The Company estimates that approximately $24,500,000 (including $14,671,606 incurred through November 30, 1971) are required to develop its products and production techniques and to acquire property, plant and production equipment. While management believes these costs will be fully recovered, the ultimate recovery of costs incurred or to be incurred is dependent upon future developments, including achievement of a level of operations which would permit such recovery. Furthermore, the Company plans to seek additional financing in order to enable it to achieve its projected level of future operations. The eventual outcome of these matters cannot be determined at this time.

The Company intends to continue deferring all costs incurred until there have been sales (except for limited amounts). The Company plans to amortize research and preoperating costs applicable to each product by charges to earnings based on units expected to be sold with a maximum amortization period of 36 months beginning with the first sales of the respective products.

The following is a summary of the changes in deferred research and preoperating costs for the two years:

	1971	1970
Balance at beginning of year	$ 4,329,398	$ 688,679
Cash disbursements	6,172,948	3,549,818
Depreciation and amortization	257,335	100,574
Interest income	(325,233)	(9,673)
Balance at end of year	$10,434,448	$4,329,398

2. Property, plant and equipment

Plant and equipment is depreciated ($257,335 and $100,574 in the years ended November 30, 1971 and 1970, respectively) on the straight-line method.

No depreciation has been recorded with respect to production facilities and equipment inasmuch as production of the Company's products has not commenced.

3. Transactions with Avco Corporation

(a) Notes payable:

The Company's activities until July 1971 were financed principally by loans from Avco Corporation which owned 50.2% of the Company's outstanding common stock at November 30, 1970 (32.2% after the public offering of stock in July 1971).

On July 12, 1971 Avco exchanged $7,100,000 of notes (including $2,000,000 for advances made after November 30, 1970) for 355,000 shares of the Company's common stock and 10-year warrants exercisable at any time to purchase 12,500 shares of the Company's common stock at $20 per share. All interest accrued as of July 12, 1971 was paid to Avco as was an additional $500,000 advanced by Avco for a short period in June and July 1971.

(b) Other transactions:

Avco Corporation has provided various services to the Company including product development, the manufacture of prototypes and preproduction startup effort, all of which has been charged to the Company on a cost reimbursement basis since inception in the aggregate amount of approximately $3,120,000. The Company has agreed to reimburse Avco for additional production startup costs estimated to be approximately $400,000.

The Company has contracted to have certain products manufactured in Avco plants. Substantial amounts of company-owned capital equipment and tooling is being installed in these plants.

4. Commitments and contingencies

(a) The Company has entered into agreements with the owners of certain film properties for the purpose of licensing the Company to use such properties with its video tape cartridges. The agreements are for varying periods of time, none of which extends beyond 1981. The agreements call for royalties to be paid by the Company at varying rates, based on sales and rentals of the video tape cartridges. Certain of these agreements call for minimum royalty payments aggregating $535,000.

(b) The Company has entered into agreements with Avco Corporation and Playtape, Inc., a company which formerly held rights and interests in a preliminary version of the CARTRIVISION recorder-player system and which is a wholly-owned subsidiary of a company controlled by an officer and certain directors of Cartridge Television Inc., pursuant to which the Company will pay annual royalties to each company equal to the lesser of $500,000 or 2% of the income of the Company derived from the CARTRIVISION system before income taxes and these royalties (which royalties may be reduced as a result of certain patent and related contingencies) for each fiscal year in perpetuity commencing with the fiscal year beginning December 1, 1973.

(c) The Company is leasing administrative offices in Palo Alto, California for three years commencing September 15, 1971. The annual rental is approximately $85,200 with provision for certain adjustments due to changes in the lessor's operating expenses.

5. Income tax

Research and preoperating costs which the Company has deferred for financial statement purposes (Note 1) are claimed as deductions for federal income tax purposes in the year incurred. As a result, the Company has operating tax loss carry-forwards of approximately $10,430,000, of which $690,000 expires in 1974, $3,640,000 in 1975 and $6,100,000 in 1976. The Company's tax returns have not been examined by the Internal Revenue Service.

6. Change of incorporation and recapitalization

The Company is a Delaware corporation having an authorized capitalization of 2,500,000 shares of $1 par value common stock. It was formerly an inactive wholly-owned subsidiary of a New York corporation having the same name and an authorized capitalization of 2,100

no par value common shares. On July 1, 1971, the New York parent was merged into the Company, and each of the outstanding common shares (no par value) of the predecessor corporation was changed and automatically converted into 300 common shares ($1 par value) of the Company's common stock.

7. Common stock reserved

At November 30, 1971 the Company had reserved for issuance an aggregate of 237,500 shares of its common stock as follows:

(a) During 1971 the Company adopted a stock option plan under which qualified and unqualified options for a total of 175,000 shares may be granted to key employees. The option price of qualified options is to be equal to the fair market value of the Company's common stock on the date of the grant. The qualified options are exercisable at the rate of one-third of the aggregate amount on each anniversary date of the option beginning one year after the date of the grant. Exercisability of the qualified options is cumulative but no portion of the option may be exercised after five years from the date of grant. Through November 30, 1971, options for 91,500 shares, of which those covering 41,500 shares are qualified and one covering 50,000 shares (having the same terms) is unqualified, had been granted at an option price of $20 per share (an aggregate of $1,830,000) none of which was exercisable at November 30, 1971.

(b) In connection with its public offering of stock in July 1971 the Company issued to Hornblower & Weeks — Hemphill, Noyes, the principal underwriter, five-year warrants exercisable at any time after July 20, 1972 to purchase 50,000 shares of common stock at $24 per share (an aggregate of $1,200,000).

(c) As explained in Note 3, in July 1971 the Company issued ten-year warrants to Avco Corporation exercisable at any time to purchase 12,500 shares of its common stock at $20 per share (an aggregate of $250,000).

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors
Cartridge Television Inc.

We have examined the accompanying statements of assets, intangibles and deferrals, liabilities and common stock and additional paid-in capital of Cartridge Television Inc. (a company in the development stage—see Note 1) at November 30, 1971 and 1970 and the related statements of cash receipts and disbursements and changes in common stock and additional paid-in capital for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note 1, the Company has incurred significant amounts of research and preoperating costs, which costs have been deferred. The Company has also acquired substantial production facilities and equipment. In addition, the Company expects to incur substantial additional expenditures to complete development of its products and production techniques and to acquire property, plant and production equipment. It is not possible at present to determine whether these costs ultimately will be recovered since recovery is dependent upon the success of future operations.

In our opinion, the statements mentioned above present fairly the cost of assets, intangibles and deferrals, the liabilities and the common stock and additional paid-in capital of Cartridge Television Inc. at November 30, 1971 and 1970 and its cash transactions and changes in common stock and additional paid-in capital for the years then ended, on a consistent basis during the period.

Arthur Young & Company

San Jose, California
December 16, 1971

Excerpt from Exhibit B to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

CARTRIVISION®

EXECUTIVE OFFICES

460 PARK AVENUE
NEW YORK, NEW YORK 10022

BOARD OF DIRECTORS

JAMES R. KERR, *Chairman*
President and Chief Executive Officer
Avco Corporation

ERNEST S. ALSON
Vice President
World-Wide Volkswagen Corporation

ALAN S. BERK
Vice President and Controller
Avco Corporation

DAVID L. COFFIN
President, The Dexter Corporation

JAMES R. DEMPSEY*
Vice President and Group Executive
Avco Corporation

VICTOR ELMALEH
Chairman of the Board and President
Magna-Dolphin Inc.

THOR W. KOLLE, JR.*
General Partner
Hornblower & Weeks-Hemphill, Noyes

ARTHUR STANTON
Chairman of the Board and President
World-Wide Volkswagen Corporation

FRANK STANTON*
President, Cartridge Television Inc.

GEORGE S. TRIMBLE
President, The Bunker-Ramo Corporation

GORDON M. TUTTLE
Vice President and General Counsel
Avco Corporation

**Executive Committee Members*

OFFICERS

JAMES R. KERR
Chairman of the Board

FRANK STANTON
President

JAMES R. DEMPSEY
Chairman of the Executive Committee

CHARLES D. BROWN
Vice President, Operations

GEORGE C. COLEMAN
Vice President, Industrial Relations

SAMUEL W. GELFMAN
Vice President, Programming and Production

DONALD F. JOHNSTON
Vice President, Marketing

DENIS B. TRELEWICZ
Vice President, Treasurer and Secretary

ROBERT A. WUELLNER
Controller

MARKETING AND ADMINISTRATION:
2465 EAST BAYSHORE
PALO ALTO, CALIFORNIA 94303

PROGRAMMING:
460 PARK AVENUE
NEW YORK, NEW YORK 10022

MANUFACTURING AND ENGINEERING:
1080 NORTH 7th STREET
SAN JOSE, CALIFORNIA 95112

CERTIFIED PUBLIC ACCOUNTANTS
ARTHUR YOUNG & COMPANY
SAN JOSE, CALIFORNIA

GENERAL COUNSEL
SHEA GOULD CLIMENKO & KRAMER
NEW YORK, NEW YORK

TRANSFER AGENTS AND REGISTRARS
MANUFACTURERS HANOVER TRUST COMPANY
NEW YORK, NEW YORK

CROCKER NATIONAL BANK
LOS ANGELES, CALIFORNIA

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Excerpt from Exhibit C to Affidavit of Laura Banfield

1972 Annual Report of Cartridge Television, Inc.

CARTRIDGE TELEVISION INC.
ANNUAL REPORT 1972

1972-1973 CORPORATE HIGHLIGHTS

MARCH 1972
First production CARTRIVISION® videotape recorder/players shipped to television receiver manufacturers.

MARCH 1972
Service Training Center opened in Palo Alto, California.

APRIL 1972
Cartridge Rental Network organized to distribute CARTRIVISION rental video cartridges.

MAY 1972
National Parts Depot established in Indianapolis, Indiana.

JUNE 1972
First CARTRIVISION systems sold to consumers by Sears, Roebuck & Co. retail outlets in Chicago, Illinois.

AUGUST 1972
CARTRIVISION stand-alone videotape playback units demonstrated in New York City.

FEBRUARY 1973
Videotape recording license acquired from Ampex Corporation in settlement of patent litigation.

MARCH 1973
California Entertainment Showcase inaugurated.

CARTRIVISION® IS A REGISTERED TRADEMARK OF CARTRIDGE TELEVISION INC.

Excerpt from Exhibit C to Affidavit of Laura Banfield

TO OUR SHAREHOLDERS

Dear Shareholders:

Although the 1972 fiscal year was a difficult and challenging one for Cartridge Television Inc., substantial progress was made during the year to establish the essential base for your Company's future operations in the newly-emerging videoplayer industry.

A listing of the major corporate highlights since the beginning of 1972 is set forth on the preceding page of this Annual Report. By far the most significant event for your Company was the commencement of retail consumer sales of CARTRIVISION® sets through various outlets of Sears, Roebuck & Co. in the Chicago area last June. Since then, CARTRIVISION sets have been offered to the public through a variety of retail outlets in the United States by Sears, Montgomery Ward & Co., Admiral Corporation and Teledyne Packard Bell, and the CARTRIVISION system continues to be the only home videoplayer system which is presently available to consumers in the United States.

In order to take maximum advantage of the current availability of the CARTRIVISION system, an intense sales effort called "California Entertainment Showcase" was recently inaugurated. This cooperative program combines the resources of the Company and television manufacturers who have adopted the CARTRIVISION system with those of local distributors and retailers in a concentrated effort to promote sales of the system and programming in the California market. Similar showcase promotions are planned for other key marketing areas in the United States, and your management is confident that these efforts will provide strong impetus to the Company's sales in 1973.

Last year a network for distributing CARTRIVISION blank and prerecorded video cartridges for consumer purchase was established, and as of March 1973, approximately 500 retail outlets in major United States marketing areas were offering these cartridges for sale. To distribute rental cartridges, which are primarily feature films, Cartridge Rental Network was organized in April 1972 as a joint venture by your Company and Columbia Pictures Industries, Inc. As part of the agreement, Columbia has made its complete library of motion pictures available to CRN. Cartridge Rental Network has to date entered into distribution agreements with Sears and seven other distributors in the United States whose territories encompass eighteen states, and additional rental distributorships are expected to be established this year.

Rights to a substantial amount of additional programming were secured by the Company during 1972 from sources which included Encyclopedia Britannica Educational Corp., American Broadcasting Company Merchandising Inc., McGraw-Hill Films, and Doubleday Multimedia. The programming material available to the Company for its prerecorded CARTRIVISION cartridges presently covers a wide variety of titles in such subject areas as art, children's education, entertainment, music, sports, theater and travel.

During mid-1973, the Company plans to introduce a stand-alone videotape playback unit. This unit, a prototype of which was demonstrated in New York City last August, is capable of being easily attached to the antenna terminals of any television receiver currently being marketed for home use in the United States and will permit users to play back prerecorded CARTRIVISION video tape cartridges. A full-feature stand-alone unit, which will permit the user to record off-the-air broadcast television shows and play back "home movies" with sound that have been taken with a hand held camera, as well as play back prerecorded material, is planned for demonstration late this year.

During 1972, your Company encountered a variety of problems in establishing its position in the videoplayer industry. Delays occurred in its marketing plans due primarily to changes in product design and production schedules and the failure

Excerpt from Exhibit C to Affidavit of Laura Banfield

of various suppliers to furnish the Company with CARTRIVISION components meeting contractual specifications. By year-end, CARTRIVISION videoplayer production had exceeded current customer requirements and production of new CARTRIVISION videoplayers was temporarily suspended in order to permit the orderly [illegible]tion of inventories. Since then, the videoplayer production facilities have be[illegible]ngaged primarily in upgrading previously manufactured units, but the Company expects production of new CARTRIVISION videoplayers to recommence in April 1973.

The foregoing delays in the Company's marketing plans substantially increased its need for working capital. In September 1972, a bank line of credit secured by the Company's accounts receivable and certain other properties was established, and this line presently permits borrowings equal to 80% of the Company's receivables, up to a maximum of $5,000,000, until February 1974. In addition, following unsuccessful efforts by the Company to obtain funds from other outside sources, Avco Corporation, the Company's principal stockholder, agreed to advance up to $13.8 million to the Company. The terms of this financing include a substantial equity participation, as described in Note 5b to the financial statements which are included in this Annual Report.

A variety of cost reduction programs were instituted by your management during the year to reduce the Company's cash needs, and these efforts are continuing. Notwithstanding these efforts, the Company may require additional outside financing to help meet its working capital needs later in 1973. The Board of Directors has determined that Cartridge Television Inc. will for accounting purposes be considered an operating company as of the beginning of the 1973 fiscal year. As described in Note 1 to the financial statements, substantial costs which were incurred through November 30, 1972 and have been deferred on the Company's financial statements will be amortized over the next five fiscal years.

Patent litigation which commenced in mid-1972 between the Company and Ampex Corporation involving the type of frequency modulation recording utilized in the CARTRIVISION system was amicably resolved in February 1973 following extensive negotiations between the parties. Under the terms of this settlement, the Company obtained a non-exclusive license covering Ampex's complete portfolio of videotape recording patents in return for the payment of minimum royalties totaling $1,500,000 over the next four years.

We record with deep regret the untimely death last August of Robert A. Wuellner who as the first Controller of the Company served its interests devotedly and well.

We are most appreciative of the understanding and support which has been given to the Company by both its shareholders and employees during this difficult period. Your management remains confident in the future of the videoplayer industry and will continue to use every effort to establish your Company as a major enterprise in this field.

James R Kerr

JAMES R. KERR, *Chairman*

Frank Stanton

FRANK STANTON, *President*

March 23, 1973

Excerpt from Exhibit C to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

STATEMENT OF ASSETS, INTANGIBLES AND DEFERRALS (NOTE 1)

November 30, 1972 and 1971

	1972	1971
Current assets:		
Cash	$ 101,665	$ 299,669
Certificates of deposit	—	14,027,407
Accounts receivable—trade, less allowance for customer returns of $384,000, pledged (Note 4)	1,099,307	—
Inventories, at lower of cost (first-in, first-out) or net realizable value:		
Finished goods	1,272,838	—
Work-in-process	1,177,546	—
Raw material	545,799	—
	2,996,183	—
Advances and prepaid expenses	118,603	375,449
Total current assets	4,315,758	14,702,525
Property, plant and equipment, at cost (Notes 2, 4 and 5):		
Land	320,506	289,681
Buildings and improvements	2,473,564	1,381,473
Equipment and furniture	3,590,177	1,208,098
	6,384,247	2,879,252
Accumulated depreciation	(932,273)	(363,067)
	5,451,974	2,516,185
Production facilities and equipment (including construction in progress of $534,866 in 1972 and $1,265,305 in 1971)	6,706,999	1,633,030
Net property, plant and equipment	12,158,973	4,149,215
Investment in affiliate (Note 3)	175,000	—
Intangibles and deferrals:		
Patents at cost	127,417	87,943
Research, preoperating and start-up costs (Notes 1 and 5)	31,280,487	10,434,448
Total intangibles and deferrals	31,407,904	10,522,391
	$48,057,635	$29,374,131

STATEMENT OF LIABILITIES

November 30, 1972 and 1971

	1972	1971
Current liabilities:		
Note payable to bank (Note 4)	$ 720,000	$ —
Accounts payable—trade	2,214,279	912,638
Accounts payable—Avco Corporation (Note 5)	1,071,213	401,548
Accrued liabilities	941,207	207,551
Long-term liabilities due within one year (Note 4)	193,354	130,200
Total current liabilities	5,140,053	1,651,937
Long-term liabilities due after one year:		
Building and equipment loans (Note 4)	262,688	281,300
Avco Corporation (Note 5)	9,114,000	—
8% notes payable to Avco Corporation (Note 5)	6,100,000	—
Commitments and contingencies (Notes 3 and 6)		
	$20,616,741	$ 1,933,237

STATEMENT OF COMMON STOCK AND ADDITIONAL PAID-IN CAPITAL

November 30, 1972 and 1971

	1972	1971
Common stock, $1 par value; 2,500,000 shares authorized, 2,082,750 issued and outstanding (Notes 5, 8 and 9)	$ 2,082,750	$ 2,082,750
Additional paid-in capital	25,358,144	25,358,144
	$27,440,894	$27,440,894

See accompanying notes.

Excerpt from Exhibit C to Affidavit of Laura Banfield

CARTRIDGE TELEVISION INC.

STATEMENT OF CASH RECEIPTS AND DISBURSEMENTS

Years ended November 30, 1972 and 1971

	1972	1971
Receipts:		
Sales of common stock, net of expenses of $189,606	$ —	$19,830,394
Interest (includes $177,407 accrued in 1971)	220,469	325,233
Proceeds of bank loans (Note 4)	3,020,000	—
Proceeds of equipment loans (Note 4)	204,094	—
Proceeds of loans from Avco Corporation (Note 5)	6,100,000	2,500,000
Sales of products	2,216,030	—
Total receipts (accrual basis)	11,760,593	22,655,627
Accrual adjustments for net receivables	(1,099,307)	—
Total receipts (cash basis)	10,661,286	22,655,627
Disbursements:		
Research, preoperating and start-up costs (Notes 1 and 5):		
Salaries and employee benefits	6,528,151	2,318,778
Materials and supplies	3,302,178	1,153,921
Interest	134,194	371,441
Avco Corporation (Note 5)	9,693,116	1,242,852
Other	3,051,914	1,085,956
	22,709,553	6,172,948
Inventories	2,996,183	—
Property, plant and equipment (Note 2)	8,578,964	2,148,438
Patent costs	39,474	33,241
Investment in affiliate (Note 3)	175,000	—
Principal payments on bank loans (Note 4)	2,300,000	—
Principal payments on building and equipment loans (Note 4)	173,396	238,500
Principal payments on Avco Corporation loan (Note 5)	—	500,000
Other	(256,846)	338,449
Total disbursements (accrual basis)	38,715,724	9,431,576
Accrual adjustments for accounts payable and accrued expenses	(11,829,027)	(1,061,349)
Total disbursements (cash basis)	24,886,697	8,370,227
Net increase/(decrease) in cash, certificates of deposit and accrued interest	(14,225,411)	14,285,400
Cash, certificates of deposit and accrued interest at beginning of period	14,327,076	41,676
Cash, certificates of deposit and accrued interest at end of period	$ 101,665	$14,327,076

STATEMENT OF CHANGES IN COMMON STOCK AND ADDITIONAL PAID-IN CAPITAL

Years ended November 30, 1972 and 1971

	Common Stock		Additional Paid-in Capital	Total
	Number of Shares	Amount		
Balance November 30, 1970	2,092½	$ 510,500	$ —	$ 510,500
Adjustment to effect reincorporation of Cartridge Television Inc. (Note 8)	625,657½	117,250	(117,250)	—
Balance after adjustment	627,750	627,750	(117,250)	510,500
Issuances of stock:				
For debt held by Avco Corporation (Note 5)	355,000	355,000	6,745,000	7,100,000
Public offering, net of $189,606 expenses	1,100,000	1,100,000	18,730,394	19,830,394
Balance November 30, 1971 and 1972	2,082,750	$2,082,750	$25,358,144	$27,440,894

See accompanying notes.

Excerpt from Exhibit C to Affidavit of Laura Banfield

NOTES TO FINANCIAL STATEMENTS

November 30, 1972 and 1971

1. Basis of financial statements; research, preoperating and start-up costs

The Company was considered to be in the development stage for accounting purposes through November 30, 1972; accordingly, all its costs from inception have been deferred. The Company has determined that it will, for accounting purposes, be considered an operating company on and after December 1, 1972. The Company intends to amortize the $31,280,487 research, preoperating and start-up costs deferred at November 30, 1972 by charges to operations in the following percentages based on estimated sales over the next five fiscal years: 1973—5.1%, 1974—16.7%, 1975—20.5%, 1976—26.0%, and 1977—31.7%. If actual sales exceed the estimates on which the minimum amortization has been calculated, amortization will be accelerated proportionately. While management believes these costs and its investment in property, plant and equipment will be fully recovered, the ultimate recovery of these costs is dependent upon the Company's ability to establish and maintain a market for its products and upon its ability to secure any additional financing it may require, neither of which is assured at this time.

The following is a summary of the changes in deferred research, preoperating and start-up costs for the two years:

	1972	1971
Balance at beginning of year	$10,434,448	$ 4,329,398
Disbursements	22,709,553	6,172,948
Depreciation	572,985	257,335
Interest income	(220,469)	(325,233)
Revenue from sales of products	(2,216,030)	—
Balance at end of year	$31,280,487	$10,434,448

2. Property, plant and equipment

Plant and equipment other than production facilities and equipment are depreciated on the straight-line method. No depreciation has been recorded with respect to production facilities and equipment because the Company was in the development stage; however, depreciation will be recorded commencing in 1973.

3. Investment in affiliate

In April 1972, the Company formed a wholly-owned subsidiary, Entertainment Rental Inc., whose only asset is a 50% investment in a joint venture known as Cartridge Rental Network (CRN). The other co-venturer is a wholly-owned subsidiary of Columbia Pictures Industries, Inc. CRN was formed for the primary purpose of renting prerecorded cartridges playable on the CARTRIVISION system. The Company produces and sells the prerecorded cartridges to CRN under a fixed price contract.

CRN was also in the development stage through November 30, 1972 and accordingly, all its costs have been deferred. The following is a summary of CRN's assets and deferrals, liabilities and venturers' equity at November 30, 1972:

Assets and deferrals:	
Cash	$200,164
Advances, receivables and prepayments	26,907
Cartridge inventory, at cost	27,000
Preoperating costs	433,655
	$687,726
Liabilities:	
Accounts payable and accrued liabilities	$ 42,479
Advances from distributors	295,247
	$337,726
Venturers' equity	$350,000

Each co-venturer is committed to contribute an additional $325,000 to the joint venture, if required.

4. Notes payable and pledged assets

The note payable to bank in the amount of $720,000 was issued under a line of credit and is secured by a pledge of all trade accounts receivable and a second deed of trust on land and buildings having a cost of $2,083,675. Under the terms of the line of credit, which expires on February 28, 1973, the Company is permitted to borrow 80% of the balance of accounts receivable, up to a maximum borrowing of $2,500,000. The Company is currently negotiating for an extension of this line of credit.

The following is a summary of building and equipment loans at November 30, 1972:

	Due in one year	Due after one year
8½% note payable, secured by a first deed of trust on land and buildings having a cost of $2,083,675, due in monthly installments of $10,850 plus interest	$130,200	$151,100
Equipment loans at varying interest rates, secured by equipment and furniture having a cost of approximately $220,000, due in monthly installments of $7,023 including interest	63,154	111,588
	$193,354	$262,688

Excerpt from Exhibit C to Affidavit of Laura Banfield

Principal payments on the building and equipment loans after 1973 are $196,501 in 1974, $39,403 in 1975, $17,103 in 1976 and $9,681 in 1977.

5. Transactions with Avco Corporation

(a) Equity ownership:

The Company's activities until July 1971 were financed principally by loans from Avco Corporation which owned 50.2% of the Company's outstanding common stock until the Company's public offering of stock in July 1971. Prior to the public offering Avco exchanged $7,100,000 of notes for 355,000 shares of the Company's common stock and ten-year warrants exercisable at any time to purchase 12,500 shares of the Company's common stock at $20 per share. Avco owned 32.2% of the Company's common stock after the public offering through November 30, 1972. If all the convertible notes and warrants described in the next paragraph were to be converted or exchanged for common stock, Avco's equity ownership in the Company would increase to approximately 50%.

(b) Notes payable:

Avco has agreed to lend the Company up to $13,800,000 at an annual interest rate 2% above the Bank of America prime lending rate, secured by a pledge of all the Company's assets, subject to prior deeds of trust and security rights (see Note 4). The Company and Avco have agreed that these advances ($6,100,000 advanced through November 30, 1972) will be exchanged for $8,000,000 principal amount of 8% subordinated notes due 1985 (convertible into CTI common stock at $20 per share) plus up to $5,800,000 of 8% subordinated notes due 1976 and six-year warrants to purchase up to 483,333 shares of CTI's common stock at $12 per share, but this exchange is subject to approval by the Company's stockholders of an increase in authorized common stock. The warrants would be exercisable by payment in cash or by surrender of the 8% subordinated notes due 1976.

(c) Other transactions:

Avco Corporation has provided various services to the Company including product development, preproduction start-up effort and initial production assemblies, all of which have been charged to the Company at Avco's cost of approximately $11,600,000 since inception, of which approximately $9,114,000 was unpaid at November 30, 1972. This latter amount will be paid at the rate of $68 (which includes a cost of money factor) per unit for the last 150,000 units of the 200,000 units to be produced in Avco plants under fixed price contracts which currently are being renegotiated. Company-owned equipment having a cost of approximately $6,400,000 is located in the Avco plants.

6. Commitments and contingencies

a. The Company has entered into agreements, none of which extends beyond 1981, with the owners of certain film properties for the purpose of licensing the Company to use such properties with its video tape cartridges. The agreements call for royalties to be paid by the Company at varying rates, based on sales and rentals of the video tape cartridges. Certain of these agreements call for future minimum royalty payments aggregating approximately $940,000.

b. The Company has entered into agreements in perpetuity with Avco Corporation and Playtape, Inc., a company which formerly held rights and interests in a preliminary version of the CARTRIVISION recorder-player system and which is a wholly-owned subsidiary of a company controlled by an officer and certain directors of Cartridge Television Inc., pursuant to which the Company will pay annual royalties to each company equal to the lesser of $500,000 or 2% of the income of the Company derived from the CARTRIVISION system before income taxes and these royalties commencing December 1, 1973.

c. The Company leases offices and a warehouse at annual rentals of approximately $345,000 in 1973, $324,000 in 1974 and $110,000 in 1975.

d. In February 1973, the Company and Ampex Corporation reached an agreement to settle certain patent litigation between them whereby the Company obtained a nonexclusive license from Ampex covering certain patents for a guaranteed minimum royalty of $1,500,000 payable in the following annual amounts: 1973—$400,000, 1974—$300,000, 1975—$400,000 and 1976—$400,000.

7. Federal income taxes

Research and preoperating costs and patent costs which the Company has deferred for financial statement purposes (Note 1) are claimed as deductions for federal income tax purposes in the year incurred. As a result, the Company has operating tax loss carryforwards of approximately $31,400,000 of which $720,000 expires in 1974, $3,664,000 in 1975, $6,125,000 in 1976 and $20,891,000 in 1977. The Company's tax returns have not been examined by the Internal Revenue Service.

8. Change of incorporation and recapitalization

The Company is a Delaware corporation having an authorized capitalization of 2,500,000 shares of $1 par value common stock. It was formerly an inactive wholly-owned subsidiary of a New York corporation having the same name and an authorized capitalization of 2,100 no par value common shares. On July 1, 1971, the New York parent was merged into the Company, and each of the outstanding common shares (no par value) of the predecessor corporation was changed and automatically converted into 300 common shares ($1 par value) of the Company's common stock.

Excerpt from Exhibit C to Affidavit of Laura Banfield

9. Common stock reserved

At November 30, 1972, the Company had reserved for issuance an aggregate of 237,500 shares of its common stock, excluding 883,333 shares which may be issuable as described in Note 5, as follows:

a. In connection with its public offering of stock in July 1971, the Company issued to Hornblower & Weeks-Hemphill, Noyes, the principal underwriter, five-year warrants exerisable at any time after July 20, 1972 to purchase 50,000 shares of its common stock at $24 per share (an aggregate of $1,200,000).

b. As explained in Note 5, in July 1971 the Company issued ten-year warrants to Avco Corporation exercisable at any time to purchase 12,500 shares of its common stock at $20 per share (an aggregate of $250,000).

c. During 1971 the Company adopted a stock option plan under which qualified and nonqualified options for a total of 175,000 shares may be granted to key employees. The option price of qualified options is to be equal to the fair market value of the Company's common stock on the date of grant. The qualified options are exercisable at the rate of one-third of the aggregate amount on each anniversary date of the option beginning one year after the date of the grant. Exercisability of the qualified options is cumulative but no portion of the option may be exercised after five years from the date of grant.

The following is a summary of changes in shares covered by options under the plan for the two years ended November 30, 1972:

		Outstanding options		
	Unissued options	Number	Price per share	Aggregate price
Plan adopted	175,000			
Options granted	(91,500)	91,500	$20	$1,830,000
Balance at November 30, 1971	83,500	91,500		1,830,000
Options granted	(21,550)	21,550	$18.50-$33.00	608,837
Options cancelled	3,950	(3,950)	$20.00-$33.00	(94,600)
Balance at November 30, 1972	65,900	109,100*	$18.50-$33.00	$2,344,237
Options exercisable at November 30, 1972		29,907	$20	$ 598,140

*Includes a nonqualified option covering 50,000 shares.

REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors and Stockholders
Cartridge Television Inc.

We have examined the accompanying statements of assets, intangibles and deferrals, of liabilities and of common stock and additional paid-in capital of Cartridge Television Inc. at November 30, 1972 and 1971 and the related statements of cash receipts and disbursements and of changes in common stock and additional paid-in capital for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note 1, the Company was in the development stage for accounting purposes through November 30, 1972 and has incurred a significant amount of research, preoperating, and start-up costs, which costs have been deferred. The Company also has incurred substantial costs for property, plant and equipment. The ultimate recovery of such costs is dependent upon the Company's ability to establish and maintain a market for its products and upon its ability to secure any additional financing it may require, neither of which is assured at this time.

In our opinion, the statements mentioned above present fairly the cost of assets, intangibles and deferrals, the liabilities and the common stock and additional paid-in capital of Cartridge Television Inc. at November 30, 1972 and 1971 and its cash transactions and changes in common stock and additional paid-in capital for the years then ended, on a consistent basis during the period.

San Jose, California
February 23, 1973

Arthur Young & Company

EXPOSURE DRAFT
March 1973

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Excerpts from Exhibit D to Affidavit of Laura Banfield

AICPA, Committee on Companies in the Development Stage, Preliminary Draft of *Audits of Companies in the Development Stage* (July 1973)

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

AUDIT GUIDE

Comments should be received by

MAY 1, 1973

Issued for comment from interested persons by the AICPA Committee on Companies in the Development Stage

Norman O. Olson, Chairman
Carl B. Burger
Ernest L. Hicks
Raymond C. Lauver
Edward J. McGowen

Comments should be addressed to:
John F. Mullarkey, Manager, Auditing Standards at the Institute's offices, 666 Fifth Avenue, N.Y., N.Y. 10019

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

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Excerpts from Exhibit D to Affidavit of Laura Banfield

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE[1]

CHAPTER 1 -- INTRODUCTION

Scope and Purpose of This Guide

The dynamic nature of the economy with its burgeoning technology has created widespread interest in new and developing companies on the part of investors.[2] Managers and directors of companies in the development stage face some unique problems when they undertake to provide financial reports that are most useful to management and investors. Consequently, a somewhat specialized application of generally accepted accounting principles is needed.

A diversity of financial reporting practices exists for companies in the development stage and the type of auditors' report has varied widely for factual situations that appear to be comparable. This audit guide recommends practices which should result in the presentation of useful financial information by these companies with less variation in the form of the financial statements and in the accompanying auditors' reports.

The recommendations presented herein are applicable to any company, in any industry, which is in the development stage.

1/ Development stage, as used in this document, also includes the promotional stage and encompasses all aspects of the activities in which a business may be engaged in order to reach the operating stage, including organizational, start-up, capital raising, research, exploratory, administrative, and similar activity.

2/ The term "investor" is used in this audit guide in the broad sense and includes creditors as well as holders of equity interests.

Nature of the Problem

In making an investment decision, one generally considers such factors as: quality of management; position of the company in its industry; potential of the industry; nature of the ownership interest; and the company's potential for innovation. One also considers financial information such as earnings history, funds flow, and financial position. However, a company in the development stage does not have an earnings history nor does it have a financial position comparable to that of an operating company. Thus, the character of information available to investors and others for companies in the development stage necessarily differs from that for more established companies. These circumstances create special reporting and auditing considerations which are discussed in subsequent chapters of this guide.

A principal problem is accounting for costs incurred by companies in the development stage, particularly costs of research and development, exploration, and preoperating activity (the latter category embraces such activities as start-up, promotional, personnel recruiting and training, market planning, administrative, and financing). The guide deals with this problem and the related problem of accounting for previously incurred costs after a company reaches the operating stage. The guide does not deal with the question of how a company which has emerged from the development stage should account for costs which it incurs after it reaches the operating stage nor with the question of how a long-established operating

company should account for exploration, promotion, and development costs.

Another problem often associated with companies in the development stage is the valuation of shares issued for property or services. The import of this problem depends on how much stock is thus issued, the extent to which shares are also issued for cash (which may provide a valuation guide for the non-cash issuances), the relationship of the parties involved to the corporation, and the availability of external indicators of fair value for the kinds of property and services exchanged for the company's stock.

These accounting problems introduce questions about the type of report that can be issued by the auditor.

Identifying Companies in the Development Stage

Whether a company is in the development stage and, consequently, whether the recommendations of this guide apply, should be determined by considering the purpose and activity of the company. A company in the development stage will be directing its efforts to establishing a business and laying a foundation for the generation of future earnings. To that end it will ordinarily be devoting a major part of its efforts to (or have under consideration) such start-up activity as research, development of a product or service, exploration for and development of natural

resources, financial planning, property acquisition, marketing studies and personnel recruitment. Also, significant preoperating costs will usually have been incurred (or can reasonably be expected) relating to financing and to the day-to-day administrative function. In particular, the description "company in the development stage" is intended to be applicable to a company that has completed its initial financing, but has not commenced its planned development stage activity. Generally, a company in the development stage will not have had significant revenues from its proposed endeavors. However, the absence of revenues will not necessarily indicate a development-stage company.

Other inappropriate criteria include lack of profitability, uncertainty of cost recovery, difficulty of valuation of consideration received for the sale of stock, or the inability of an auditor to express an opinion on financial statements, if issued in conventional form. These conditions often exist for companies in the development stage, but they may also exist for companies in the operating stage.

The duration of the development stage depends on a variety of circumstances, including the nature of the company's preoperating activities, the capability of its management and the vagaries of fortune. For some companies, such as a franchised sales business opening in facilities that are ready to operate, or

a company organized solely to hold investments, getting started may be so simple that a development stage, while it may in theory exist, will not as a practical matter be recognizable; such a company should not use development-stage accounting. For other companies, such as an industrial enterprise working to overcome complex technical problems in bringing its intended product to a marketable stage or a mining company attempting to locate mineral resources or preparing to exploit them, the development stage may extend for a number of years.

The end of the development stage will generally be indicated by the completion of identifiable development projects and the beginning of the intended business activities. For a company engaged in a number of such projects, completion of a major project and the generation of significant revenue from the fruits thereof will often indicate that the type of reporting appropriate for companies in the development stage should no longer be used, even though development activities continue. Another indication would be a representation by management and the board of directors that in their judgment the development stage had been concluded.[3]

3/ "...the answer to the question of when a company has begun operations is best left to management, subject to review by its independent auditors. Examples of some of the factors to be considered in answering this question are: the amount and trend of sales, sales backlog, the relationship of sales prices to related direct costs, the overall state of development of the company's production, marketing and administrative capabilities, and budgets and projections of future operating results." Wharton, Don, "Accounting and Reporting for Companies in the Development Stage," The Journal of Accountancy, July 1970.

The guide does not apply to established companies developing new products, services or markets, or to the development activities of their subsidiaries, even though the subsidiaries are in the development stage, when included in consolidated financial statements. It does, however, apply to separate financial statements of a subsidiary in the development stage and is applicable to consolidated financial information when the group as a whole is considered to be in the development stage.

The guide also does not ordinarily apply to companies which have previously issued conventional financial statements since these companies are presumed to have passed from the development to the operating stage. A dormant company which is activated or reactivated to undertake new ventures, or a company which discontinues its former business for a new line of business, may be an exception. Also, in rare cases, a company may have commenced operations, issued conventional financial statments and then returned to the development stage. Under these circumstances, previously issued conventional financial statements have little relevance and the reporting recommended in the guide should apply. However, reverting to development stage reporting is appropriate only if the company has clearly ceased being an operating company and if the change in circumstances is so substantial that conventional historical financial statements would be virtually useless.

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

CHAPTER 2 - BACKGROUND, HISTORY, AND CURRENT STATUS OF REPORTING BY COMPANIES IN THE DEVELOPMENT STAGE

Background Prior to 1948

Only in rare instances does accounting literature give more than brief consideration to accounting for companies in the development stage, and even then the discussions provide no clear consensus about the most useful accounting and reporting methods.

The organization which has had the most influence on reporting practices for companies in the development stage is the Securities and Exchange Commission. Almost from the day it was organized, the Commission was troubled by what it considered questionable presentations by promotional and exploratory mining companies. In 1936 it adopted Form A-0-1 (under the Securities Act of 1933), which required special financial statements for certain corporations engaged in the exploitation of mineral deposits other than oil or gas. Form A-0-1 was superseded in 1941 by Forms S-2 and S-3. These forms provided for separate statements of: (1) assets and capitalized expenses, (2) liabilities, (3) capital shares, (4) other securities, and (5) cash receipts and disbursements. The 1936 pronouncement contained no reference to other types of development stage companies, but subsequent revisions extended coverage to almost all commercial, industrial, or mining companies meeting the Commission's definition of companies in the promotional, exploratory, or development stage. However, none of

applications for registration or in annual reports (such as Forms 10, 10-K, or 1-MD) required to be filed under the Securities Exchange Act of 1934.

1948--Article 5A

In October 1948 the Commission made its second major pronouncement concerning development-stage companies by adding Article 5A to Regulation S-X, which governs the form and content of financial statements filed with the Commission. Article 5A extended the use of the segmented financial statements previously required only in Forms S-2 and S-3. It made these requirements applicable to financial statements of companies in the promotional, exploratory, or development stage when such statements are included in registration statements and annual reports required to be filed under the Securities Exchange Act of 1934 as well as when included in Forms S-2 and S-3 under the Securities Act of 1933.

The chairman of a subcommittee on mine accounting in a November 1948 report to the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (AICPA) commented on this action as follows:

> "It has long been recognized by the Securities and Exchange Commission and the mining industry that the usual forms of financial statements were not satisfactory for enterprises in the development stage particularly those engaged in the mining of non-ferrous metals ... Many mining companies and some companies engaged in the exploitation of patents or similar enterprises may remain in the development stage for a long time. They may enter the production stage for a period and revert to the development stage or to a condition very similar to it. Until the issuance of this new rule companies of this type were required to present financial statements in the conventional form of balance sheets, income and surplus accounts. As use of such forms assumes the existence of a going concern, it is only natural that their use for an enterprise which has not yet started operations will raise many questions and will create serious problems."

Article 5A and Forms S-2 and S-3 define a company in the development stage indirectly, in specifying applicability. In general, they identify development-stage companies by reference to the nature and significance of revenues from the sale of products or services.

In the Article 5A statements, property, plant, equipment, and services acquired for securities, and capital shares issued in exchange for property and services, often are not extended in dollar amounts but rather in numbers of shares. The problem of valuation of these noncash transactions is thus deferred, to be faced later when the company prepares conventional statements and accordingly must assign dollar values to the transactions. There are no special guidelines as to when the dollar amounts should be recorded and how they should be classified. Furthermore, Article 5A statements may include material amounts of unrecovered promotional, exploratory, and development costs and may include other accumulated expenditures as well. The question of whether, and when, these costs should be amortized or written off is not dealt with in Article 5A.

Use of Article 5A Statements

A review of recent filings indicates that the Securities and Exchange Commission's current practice encourages submission of conventional balance sheets for registration statements of development stage companies if it is possible to assign dollar amounts to all significant noncash transactions. Otherwise, Article 5A statements are required.

Excerpts from Exhibit D to Affidavit of Laura Banfield

In annual reports, both in published reports to stockholders and in reports filed with the Commission on Form 10-K, use of Article 5A statements appears to be rare. Thus, statements completely in accord with Article 5A apparently are used primarily in registration statements filed on Forms S-2 and S-3 by companies that have had significant noncash transactions to which dollar amounts have not been assigned. However, the precise status of Article 5A statements is unclear. It seems fair to conclude, at least, that the proliferation of companies in the development stage, and their visibility in the capital markets were not envisioned when the Article 5A statements were designed.

Unrecovered Research, Development, and Preoperating Costs

Development stage companies record at cost, for both conventional and Article 5A statements, the property and services acquired in connection with research, development, and preoperating activity when paid for with cash or other clearly measurable consideration. When such items are acquired for capital shares, it may be difficult to determine dollar amounts for the transactions. The Article 5A statement form acknowledges this difficulty by requiring both the items required and the capital stock issued to be stated in numbers of shares only. However, a balance sheet may not be prepared on this basis; dollar amounts must be assigned to all transactions before a balance sheet can be prepared.

A review of conventional balance sheets submitted by development stage companies indicated a lack of uniformity as to what costs were carried forward. In some of these statements, all types of accumulated expenditures were carried forward. (However, the Commission staff has informally required charge-off of expenditures known to be unrecoverable; such expenditures would presumably include costs attributable to abandoned projects. Article 5A requires disclosure of the amount of the costs written off.) Some companies have charged off part or all of certain types of costs, such as those associated with general and administrative activity, so that only a portion of the accumulated expenditures were in the unrecovered category. Still other companies not filing a registration statement with the SEC have charged off all costs other than those identified with specific tangible and intangible assets.

When a company passes from the development stage to the operating stage, it faces the question of what to do with the costs incurred while it was still in the development stage and not charged off. While the current practices are anything but uniform, the most prevalent policy noted is to amortize such costs over a short period of time, usually not more than five years. However, other bases noted were: (1) lump sum write-off at the end of the development period, and (2) amortization over the first year of operations.

To summarize, concerning the broad question of accounting for costs incurred during the development stage, particularly those relating to research and development and preoperating activity, there is considerable variety of practice both during and after the development stage.

Auditors' Reporting Practices

Nowhere has the diversity in accounting for and reporting on companies in the development stage been more apparent than in the wide variety of auditors' reports on statements filed with the Commission as part of registration statements on Forms S-2 and S-3. The auditors' reports have referred to a wide range of bases of fair presentation for Article 5A statements. Some of the bases were: (1) generally accepted accounting principles, (2) generally accepted accounting principles for companies in the development stage, (3) requirements of the Securities and Exchange Commission, (4) the information stated therein, and (5) no stated basis (the most prevalent basis noted).

An American Institute subcommittee on mine accounting worked closely with the staff of the Securities and Exchange Commission at the time Accounting Series Release No. 66 was issued in 1948. This subcommittee recommended the following form of auditors' report:

> "We have examined the statements of assets and unrecovered promotional, exploratory and development costs, of liabilities and of capital share of ..... Company as of December 31, ... and the statements of cash receipts and disbursements for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances"

Excerpts from Exhibit D to Affidavit of Laura Banfield

"In the accompanying statements of assets and unrecovered promotional, exploratory and development costs and of capital shares, the property acquired for capital shares and capital shares issued for services and property have been stated in numbers of capital shares rather than in dollars. This, in our opinion, represents an acceptable method of presenting the accounts of this company.

"In our opinion, the accompanying statements of assets and unrecovered promotional, exploratory and development costs, of liabilities, of capital shares and of cash receipts and disbursements present fairly the assets and unrecovered costs, liabilities and capital of the company at December 31, ... and its cash transactions for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

There have been numerous departures from this recommended opinion.

Excerpts from Exhibit D to Affidavit of Laura Banfield

APPENDIX

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Preoperating Accountability Statement
as of December 31, 1972

Cash and Investments -			
Cash		$ 17,000	
Marketable securities, at market value on date of receipt, which is below present market value ($42,000)		40,000	$ 57,000
Investment in undeveloped land, at cost			25,000
Inventories and Prepayments, at cost -			
Inventories of parts and supplies		$ 5,500	
Prepaid rent		500	6,000
			$ 88,000
Less - Liabilities -			
Accounts payable		$ 8,000	
Salaries and taxes payable		2,000	
Long-term loan, 12% - due July 1, 1977		30,000	$ 40,000
			$ 48,000
Cumulative Outlays for (Notes 1 and 3) -			
Machinery and equipment*		$ 46,000	
Patents, at cost		20,000	
Research and development	$ 92,000		
Deduct:			
Cost of abandoned project	32,000		
Revenue from research fees	7,000		
	$ 39,000	53,000	
Preoperating costs for adminstrative, market planning and organizational activities and interest		60,000	$ 179,000
Investment by Stockholders, net - per accompanying statement			$ 227,000

* Ordinarily, recoverability of costs incurred for plant and equipment is contingent on the outcomes of the same uncertainties that apply to the recoverability of costs incurred for research, development and preoperating costs. If recoverability of the cost of machinery and equipment is assured to a considerably greater degree, such cost may appropriately be included in the total from which liabilities are deducted. Ordinarily, the cost of land, and in some instances the cost of buildings, may also appropriately be included in that total.

Excerpts from Exhibit D to Affidavit of Laura Banfield

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Statement of Investment by Stockholders
For the Period April 1, 1971 (inception) to December 31, 1972

	Number of Shares Issued and Outstanding	Amount
Common stock, no par value, authorized 500,000 shares		
Issued for cash and marketable securities -		
Cash at $1.00 per share	$ 40,000	$ 40,000
Cash at $3.00 per share	40,000	120,000
Marketable securities, valued at quoted market value at date of receipt	22,000	40,000
Issued for other property, at estimated fair value at date of receipt as determined by the Board of Directors (Note 1) -		
Inventory	2,000	4,000
Machinery and equipment	4,000	8,000
Patents	20,000	20,000
Issued for services, at estimated fair value at date of receipt as determined by the Board of Directors -		
Rent	1,000	3,000
Officers' salaries	4,000	4,000
Other	2,000	6,000
Financial consultation	12,000	12,000
Research and development costs	2,000	2,000
Balance December 31, 1972	$ 149,000	$ 259,000

	Investment by Stockholders
Balance December 31, 1972 -	
Common stock	$ 259,000
Deduction - Cost related to abandoned project	(32,000)
	$ 227,000

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Statement of Preoperating Financial Activities

Cumulative Since April 1, 1971 (Inception) and for the Year Ended December 31, 1972

	Year - 1972		Cumulative to December 31, 1972	
Source of Financial Resources:				
Proceeds from issuance of shares for (see accompanying statement) -				
Cash and marketable securities	$120,000		$200,000	
Other property	20,000		32,000	
Services	12,000	$152,000	27,000	$259,000
Long-term loan		30,000		30,000
Revenue from research fees		6,000		7,000
Total sources		$188,000		$296,000
Use of Financial Resources:				
Investment in undeveloped land		$ 25,000		$ 25,000
Inventory of parts and supplies		-		5,500
Prepaid rent		-		500
Machinery and equipment		26,000		46,000
Patents		20,000		20,000
Research and development		55,000		92,000
Market development costs		5,000		5,000
Organization costs		-		1,000
General and administrative costs -				
Officers' and office salaries	$ 6,000		$ 24,000	
Rent	2,000		6,000	
Financial consultation	-		12,000	
Other	7,000	15,000	12,000	54,000
Total financial resources used		$146,000		$249,000
1972 excess of sources over uses		$ 42,000		
Excess of cash and marketable securities over accounts payable and accrued liabilities:				
As of December 31, 1971		5,000		
As of December 31, 1972		$ 47,000		$ 47,000
Represented by:				
Cash			$ 17,000	
Marketable securities			40,000	$ 57,000
Less accounts payable and accrued liabilities				10,000
				$ 47,000

Excerpts from Exhibit D to Affidavit of Laura Banfield

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Notes to Financial Statements

Note 1 - Basis of Financial Statements

The accompanying financial statements give recognition to the facts that the company is in the development stage and has no operating history. Except for costs associated with an abandoned project, all costs incurred, reduced by revenues, have been accumulated because they were incurred in the expectation that they would benefit future periods. It is not practicable, at the present stage of the company's activities, to determine the extent of recoverability of the accumulated research, development or preoperating costs or of the costs incurred for property, plant, equipment or patents. Recoverability is dependent on future events, including the ability of the company to raise any needed additional capital, to attain the goals of its development program, to market its products successfully and to achieve a satisfactory level of operations. The outcome of these matters cannot be determined at this time.

In the accompanying financial statements, transactions effected in cash or by acquiring or incurring obligations payable in cash have been recorded at the amounts thereof. The costs ascribed to assets or services acquired in exchange for shares of capital stock and the amounts assigned to the capital stock thus issued have been the fair values of the assets or services at the dates of receipt as determined by the board of directors giving consideration to such factors as replacement cost, bona fide offers, and recent cost to a developer. The major exchange

transactions which have occurred were the following:

(a) The issuance of 20,000 shares of stock for all of the rights to a patent owned by the president of the company who owned 20% of the 40,000 shares outstanding prior to the issuance. The amount ascribed to this exchange by the board is the amount which it would have been willing to pay in cash, and for which it believes it could have acquired such patent rights.

(b) The issuance of 12,000 shares of stock to an individual, who was previously unrelated to the company, for management consulting services rendered. These shares were valued at the amount billed, which the individual has informed the board was based on his regular billing rates for such services.

Note 2 - Federal Income Taxes

The company, being in the development stage and without earnings, has no liability for Federal income taxes. At December 31, 1972, it had net operating loss carryforwards of $145,000 expiring in 1976 and 1977. Of this amount, $32,000 has been charged to capital and $113,000 has been accumulated in the preoperating accountability statement. Any tax benefits resulting from carryforward of the former amount will be credited to capital; additional benefits will be credited to deferred tax accounts if realized before the related accumulated costs are charged to income.

Excerpts from Exhibit D to Affidavit of Laura Banfield

Note 3 - Future Accounting Policies

Depreciation is not being recorded while the company is in the development stage. The company intends when it reaches the operating stage to use the straight-line method of depreciation for plant and equipment, to amortize the research and development costs accumulated during the development stage against the first model production run and to write off accumulated preoperating costs by the straight-line method over a three-year period.

Excerpts from Exhibit E to Affidavit of Laura Banfield

FASB, Discussion Memorandum, *Accounting for Research and Development and Similar Costs* (Dec. 28, 1973)

FASB DISCUSSION MEMORANDUM

an analysis of issues related to

Accounting for Research and Development and Similar Costs

Financial Accounting Standards Board
HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905

Excerpts from Exhibit E to Affidavit of Laura Banfield

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Excerpts from Exhibit E to Affidavit of Laura Banfield

CHAPTER IV

COMPANIES IN THE DEVELOPMENT STAGE

Introduction

Up to this point, this Discussion Memorandum has been concerned solely with research and development and similar costs incurred by *established operating companies* with the expectation of deriving future benefits. Companies that have not yet reached an operating status—that is, *companies in the development stage*—also incur research and development and similar costs with the expectation of deriving future benefits. Accordingly, it is necessary to consider whether the circumstances of companies in the development stage are sufficiently unique to require accounting standards that are different from the accounting standards applicable to established operating companies. This broad question will be considered by addressing the following issues:

How might the distinction between established operating companies and companies in the development stage be delineated?

Are the differences between established operating companies and companies in the development stage of sufficient significance to warrant different accounting standards?

What different accounting standards, if any, are appropriate for companies in the development stage?

What are the special accounting problems of companies in the development stage?

ISSUE EIGHT: HOW MIGHT THE DISTINCTION BETWEEN ESTABLISHED OPERATING COMPANIES AND COMPANIES IN THE DEVELOPMENT STAGE BE DELINEATED?

The necessity of defining a company in the development stage arises only if different accounting standards are appropriate for companies in the development stage and for established operating companies. Presumably, if different standards are not required, a definition is made unnecessary.

Ideally, the definition of a company in the development stage will be both mutually exclusive and exhaustive. That is, the definition should include all companies which are, in fact, companies in the development stage and exclude any companies which are not. Unfortunately, this ideal state may not be attainable since some companies may fall in the "gray area" lying between those which are definitely companies in the development stage and those which are established operating companies.

A review of the literature reveals no precise definition of a company in the development stage. Rather, most definitions rely on stated or implied references to certain characteristics of companies in the development stage. The following characteristics are commonly cited:

6 (1) Planned Principal Operations Not Yet Begun. For example, Wharton states that "...the essential and distinguishing characteristic of the development stage is that the company is getting ready to conduct operations but has not yet begun them."[1]

7 (2) No Significant Revenues. For example, the SEC requires that its Form S-2 be used for registration by a company that, among other things, "has not had any substantial gross returns from the sale of products or services, or any substantial net income from any source, for any fiscal year ended during the past five years."[2]

8 (3) Actively Preparing to Operate. For example, the AICPA Committee on Companies in the Development Stage states that "...a company in the development stage will be directing its efforts to establishing a business and laying a foundation for the generation of future earnings."[3]

9 Some sources indicate that the first characteristic is probably the most effective in identifying a company in the development stage. In addition to the above characteristics, definitions may contain lists of activities which are considered typical of such a company. Among the activities most frequently listed are:

(1) Personnel recruitment and training
(2) Development of a product or service
(3) Financial planning
(4) Raising capital
(5) Establishing sources of supply
(6) Acquiring plant and equipment
(7) Developing markets

10 The AICPA Committee has combined some of these characteristics and activities in describing a company in the development stage as follows:

> A company in the development stage will be directing its efforts to establishing a business and laying a foundation for the generation of future earnings. To that end it will ordinarily be devoting substantially all of its efforts to (or have under consideration) such start-up activity as research, development of a product or service, exploration for and development of natural resources, financial planning, property acquisition, marketing studies, personnel recruitment and raising capital. Also, significant preoperating costs will usually have been incurred (or can reasonably be expected) relating to financing and to the day-to-day administrative function. In particular, the description "company in the development stage" is intended to include a company that has completed its initial financing (seed money), even though it has not commenced its other planned development stage activities. Generally, a company in the development stage will not have had significant revenues from its proposed endeavors.[4]

11 Others have suggested that the above description is too subjective because of the difficulty in applying the terms "substantially" and "significant." Some degree of objectivity might be supplied by devising quantitative guideline(s), such as (a) an absolute amount of revenues, (b) revenues as a percent of the current year's costs that would be expenses if incurred by an established operating company, (c) revenue as a percent of cumulative deferred

costs, (d) production costs as a percent of research and development costs, (e) percent of total personnel engaged in production or other continuing operations versus start-up activities such as financial planning, marketing studies and recruiting.

A prescribed time period might provide an objective test. The AICPA Committee, however, observed that the duration of a development stage varies widely:

> The duration of the development stage depends on a variety of circumstances, including the nature of the company's preoperating activities, the capability of its management and the vagaries of fortune. For some companies . . .getting started may be so simple that a development stage, while it may in theory exist, will not as a practical matter be recognizable . . For other companies, such as an industrial enterprise working to overcome complex technical problems in bringing its intended product to a marketable stage or a mining company attempting to locate mineral resources or preparing to exploit them, the development stage may extend for a number of years.[5]

Another objective test that has been suggested calls for the termination of the development stage when cumulative "profit" is equivalent to cumulative costs that would have been expensed if incurred by an established operating company. In effect, any "profit" resulting from the early operations of a development stage company would reduce the cumulative amount of deferred costs; when the cumulative amount of deferred costs was thus eliminated, the company would automatically emerge as an established operating company. This test might have to be supplemented by other tests; otherwise, because of insufficient "profit" to offset substantial deferred costs, a company might remain in the development stage indefinitely.

Any definition of a company in the development stage will probably need to accommodate the possibility of an established operating company's reverting to a development stage.[6] If such a possibility is deemed realistic, the definition should provide a basis for determining when an established operating company has reverted to the status of a company in the development stage.

SEC and AICPA pronouncements have in certain instances specifically excluded transactions of the extractive industries from the scope of their requirements. This Discussion Memorandum excludes from this project only those "costs that are incurred uniquely in the extractive industries." Therefore, whether extractive industry companies in the development stage have sufficiently different characteristics to warrant exclusion from or special handling in a definition of a company in the development stage requires consideration.

Two sources state that extractive industry companies in the development stage do not deserve special treatment. The recommendations of the AICPA Committee were "applicable to any company, in any industry, which is in the development stage."[7] Also, the report of the APB Committee on Extractive Industries stated, "new companies still in the exploratory and development stage in the oil and gas industry are no different than companies in a similar stage in other industries and probably should not be afforded any special treatment . . .It is quite likely that whatever decisions are made for development stage companies in general will also apply to development stage companies in the oil and gas industry and that they will not have to be dealt with separately."[8]

On the other hand, at least some of the transactions entered into by development stage companies in the extractive industries may share the unique nature that requires special consideration in the case of established operating companies in the extractive industries. The

need for such special consideration is the reason for excluding from this project costs that are incurred uniquely in the extractive industries. It might be confusing to embrace all transactions of extractive industry companies in the development stage and exclude consideration of certain identical transactions of established operating companies. In the case of companies in the development stage, it might be wiser to exclude the extractive industries completely and consider such companies at the same time that the unique accounting problems of the extractive industries generally are considered.

18 With respect to companies in the development stage, the SEC distinguishes between (1) commerical and industrial companies and (2) mining companies. However, the information requirements for commercial and industrial companies (Form S-2) and for mining companies (Form S-3) are substantially the same. The differences center on the descriptions of the business and property of the two kinds of companies. Commercial and industrial companies must describe their products; provide production information; indicate any dependence upon patents, rights, trademarks, licenses and the like; and acknowledge the significance of any seasonal and competitive characteristics. Mining companies, on the other hand, must describe each mine in some detail with respect to its location, accessibility, history of operations, present state of development, mineralization, the company's right to hold or operate it, and the proposed development program.

19 ISSUE NINE: ARE THE DIFFERENCES BETWEEN ESTABLISHED OPERATING COMPANIES AND COMPANIES IN THE DEVELOPMENT STAGE OF SUFFICIENT SIGNIFICANCE TO WARRANT DIFFERENT ACCOUNTING STANDARDS?

20 Alternative accounting treatments for research and development and similar costs incurred by an established operating company were discussed in Chapter III. Presumably, that discussion will help in formulating accounting standards applicable to established operating companies. The differences between companies in the development stage and established operating companies should also be examined in order to determine whether the same standards should apply to both types of companies or whether any different standards should apply to companies in the development stage. Arguments for and against different accounting standards are also presented.

DIFFERENCES BETWEEN ESTABLISHED OPERATING COMPANIES AND COMPANIES IN THE DEVELOPMENT STAGE

21 The AICPA Committee concluded that, for financial reporting purposes, a company in the development stage is different from an operating company.[9] In support of that conclusion, the Committee and others have asserted that companies in the development stage have several unique features. The following may be especially pertinent to the consideration of different standards for companies in the development stage:

(1) High degree of uncertainty
(2) Emphasis on development activities
(3) Lack of operating history

(1) High Degree of Uncertainty: Available statistics reveal that more than 50% of all companies that fail do so in the first five years of existence.[10] Creditors, investors, managers, auditors, and the SEC recognize the high degree of uncertainty of success for most companies in the development stage and modify their behavior accordingly. 2

Creditors typically charge higher interest rates, insist on stronger collateral, and restrict the incurrence of additional debt. 2

Many investors avoid commitments to companies in the development stage due to the high degree of uncertainty. Some institutions (e.g., insurance companies and employee trust funds) are precluded by statute from committing funds to high-risk investments. Therefore, compared with the capital market available to most established operating companies, the capital market available to companies in the development stage is restricted. If investors are discouraged from investing in companies in the development stage by the inherent uncertainty involved, they must also perceive encouraging factors that offset the unusual risks. Otherwise, they would not make such an investment. One important encouraging factor may be the possibility of above-normal return on investment. 2

Recognizing the difficulties of obtaining capital, managers of companies in the development stage often become more aggressive in their attempts to acquire financing. As a result their claims may become misleadingly optimistic.[11] According to the AICPA Committee, "Almost from the day it was organized, the [Securities and Exchange] Commission was troubled by what it considered questionable presentations by promotional and exploratory mining companies."[12] 2

The SEC has specific filing instructions (Forms S-2 and S-3) for companies in the development stage and a related specialized financial statement format (Regulation S-X, Article 5A). The specialized format deals with the uncertainty of cost recoverability and the inability to objectively value the non-cash consideration received for capital shares. 2

Wharton points out that auditors also view the uncertainties of companies in the development stage as significantly different from the uncertainties of established operating companies and modify their behavior accordingly: 2

> Since a balance sheet is prepared on the basis of generally accepted accounting principles, and since generally accepted accounting principles imply recoverability, a material uncertainty as to recoverability requires that the auditor qualify his opinion or disclaim an opinion on a balance sheet . . .Some auditors appear to take the position that 5A statements need not be based on generally accepted accounting principles, and therefore the auditor does not have to qualify or disclaim because of such an uncertainty. He may remain silent as to generally accepted accounting principles and report that the statements present fairly the cost of assets and deferred costs or the other information discussed above.[13]

If the high degree of uncertainty typical of companies in the development stage causes users, preparers, and auditors of financial information to alter their behavior, it might be argued that different accounting standards are warranted. 2

(2) Emphasis on Development Activities: A company in the development stage emphasizes primarily the development of new products and/or markets; an established operating company emphasizes primarily the production and marketing of existing products. Because a company in the development stage has not started its planned operations, the costs incurred to develop new products and/or markets are likely to represent a very large 2

proportion of its total costs. In contrast, for many established operating companies, product development and market development costs may be such an insignificant proportion of total operating costs that investors' analyses may be unaffected by diverse accounting treatments for such development costs.

30 In addition, because companies in the development stage have no substantial operating revenues, perhaps the most meaningful measurement of management's effectiveness is obtained by reviewing both successful and unsuccessful development outlays. Thus, information about development costs which might not be significant for established operating companies may become crucial for companies in the development stage.

31 Perhaps the emphasis on development activities by companies in the development stage creates a need for different accounting standards.

32 (3) Lack of Operating History: In most cases, a company in the development stage has no operating history. Crooch and Collier assess the effect of this situation as follows:

> The absence of a "track record" for a developing company, i.e., how well management has done in the past, removes one of the most objective means of predicting how well management will do in the future. Since the company was non-existent in the past, no comparative financial statements are available for analysis.
>
> The absence of a track record also limits the evaluating procedures of financial analysts. These experts have no historical data upon which to rely when formulating their assessments of a developing company's potential. If a developing concern and a going concern are subjected to the same predictive techniques (regardless of the level of sophistication), one would expect the going concern's data to be used more effectively because past experience had provided clues for proper modification of the information.[14]

33 The importance of this consequence of being a company in the development stage is underscored by the fact that nearly all investment decision models depend to some degree upon historical financial and operating data.

34 At the same time, development activities may require material amounts of capital. For established operating companies, at least a part of this needed capital may be provided by earnings retained in the business. But a company in the development stage has no earnings to retain; all the needed capital must be obtained from external sources.

35 Thus, a paradox arises—one of the tools used for investment evaluation by those with capital to invest is missing at a time when capital requirements are most crucial. The absence of historical data to help evaluate performance and the continuing need for capital may constitute distinctive features that warrant different accounting standards for companies in the development stage.

36 The overriding question, of course, is whether all of these features (and any others not mentioned), taken together, call for different accounting standards for companies in the development stage.

ARGUMENTS FOR AND AGAINST DIFFERENT ACCOUNTING STANDARDS FOR COMPANIES IN THE DEVELOPMENT STAGE

37 The following list of arguments for and against different accounting standards for companies

in the development stage is drawn from a variety of sources: speeches, accounting journals, finance journals, government documents, and authoritative pronouncements. No implication as to the validity or strength of the arguments is intended by their volume, their order of presentation, or the fact that favorable arguments precede opposing arguments.

Arguments concerned exclusively with possible special disclosures are presented in a subsequent section.

Arguments Favoring Different Accounting Standards

(1) By definition a company in the development stage has no operating performance record to present; revenues are either non-existent or immaterial. If such a company were required to treat incurred costs as expenses in a conventional income statement, the resulting operating "loss" would be a meaningless (if not misleading) measure of the success of management. Instead the focus of any financial reporting should be on the nature and cumulative cost of development activities to date and the results of these activities.

(2) Development stage costs cannot be *expenses* because there are no current revenues to which they can be related. At the same time, these costs do not involve the acquisition of *assets* because of the uncertainty of future benefits. A different accounting standard for companies in the development stage is necessary, therefore, in order to accumulate development stage costs in a *special category.*

(3) Companies in the development stage are different from established operating companies in make-up, activity, and purpose. These facts can be communicated more easily to interested parties if different accounting standards are required.

(4) Because users of accounting data recognize the fact that companies in the development stage are different from established operating companies, they expect different accounting standards.

(5) The ultimate economic value stemming from preoperating activities is dependent upon a firm's success in attaining operating status. Implicit in current accounting requirements is the assumption that operating status has already been attained. Therefore, different accounting standards are necessary.

(6) All costs of a company in the development stage are incurred to produce future revenues. If all or some of the current costs are written off as expenses, as they might be with established operating companies, costs are not properly matched to revenues subsequently generated. As a result, income is understated in the period of the expenditure and overstated in the period of the resultant revenue.

(7) Established operating companies may be permitted to defer some research and development and similar costs and to expense others. Presumably, deferral would be appropriate when the costs will generate future, rather than current, revenues. Because all revenues for companies in the development stage will necessarily occur in the future,

none of the costs should be written off in current periods. A different standard for companies in the development stage should require deferral of all costs.

46 (8) The development stage is usually characterized by great uncertainty. For companies in the development stage, the best interests of investors would be served by different accounting standards which are more conservative than accounting standards for established operating companies.

47 (9) The application of accounting standards for established operating companies will result in deficits for companies in the development stage which may unnecessarily discourage investors and impede acquisition of vital capital. Accounting standards for companies in the development stage should enable these companies to portray the economic substance of the preoperating stage without unnecessarily discouraging investors.

48 (10) Typically, financial analysts and investors make adjustments to reported information in their decision process. In order to make the data more useful, different accounting standards should attempt to reduce the number of adjustments required by users of accounting data.

Arguments Opposing Different Accounting Standards

49 (1) The economic substance of the transactions of companies in the development stage does not differ from that of established operating companies. Different accounting standards are, therefore, unnecessary.

50 (2) Different accounting standards for companies in the development stage may be confusing. Users of financial statements are accustomed to the standards and reports applicable to established operating companies.

51 (3) Empirical research suggests that, as long as information is available to investors (through the accounting process or elsewhere), they will modify their behavior in the aggregate to reflect the economic essence of the information supplied. This suggests that different accounting standards are unnecessary as long as investors are given sufficiently informative disclosures.

52 (4) Empirical research suggests that accounting information is a small part of the total information used by investors in their decision process. The application of different accounting standards would incur an additional cost but would have virtually no effect on investors' decisions.

53 (5) Any different standards for companies in the development stage that would preclude treating costs as expenses when incurred may mislead investors by implying unjustified assurance of the recoverability of costs.

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(6) Investors expect losses during the early stages of a development stage company's existence; failure to show losses may mislead investors by implying superior earning power.

(7) Financial analysts and other users of financial statements recognize the limitations of current accounting treatments of research and development and preoperating costs and make appropriate adjustments. If different accounting standards are required, the adjustments by users of financial information may become more complicated.

(8) Different accounting standards would complicate or make impossible (a) comparisons between companies in the development stage and established operating companies and (b) interperiod comparisons for a company emerging from the development stage.

(9) The financial information resulting from different accounting standards which rely heavily on subjective judgments regarding the recoverability of costs or on other subjective considerations may not be verifiable.

(10) Surveys suggest that users of accounting information prefer that the same standards be applied to companies in the development stage and to established operating companies. An expense is an expense and an asset is an asset, irrespective of whether the firm incurring the cost is a company in the development stage or an established operating company.

(11) When a company in the development stage becomes an established operating company, additional problems will arise in making the transition from tne development stage to operating status if different accounting standards are required.

(12) Different accounting standards complicate the consolidation of the financial statements of companies in the development stage with those of established operating companies.

(13) Recognition of companies in the development stage as a separate category for which different accounting standards are appropriate would also require recognition of companies in the declining stage as another separate category for which different accounting standards would presumably be necessary.

ISSUE TEN: WHAT DIFFERENT ACCOUNTING STANDARDS, IF ANY, ARE APPROPRIATE FOR COMPANIES IN THE DEVELOPMENT STAGE?

Different accounting standards, if any, which are appropriate for companies in the development stage might take any or all of the following forms:

(1) Different accounting treatments at the time costs are incurred and/or for subsequent disposition.

(2) Different primary financial statements.

(3) Special disclosures (irrespective of whether different accounting treatments and/or different primary financial statements were required).

(1) DIFFERENT ACCOUNTING TREATMENTS

64 The alternative accounting treatments described in the preceding chapter for costs incurred by established operating companies also apply to the costs incurred by companies in the development stage. However, if the arguments favoring different accounting treatments are found to be convincing, the accounting treatments determined to be appropriate for companies in the development stage may be different from the accounting treatments determined to be appropriate for established operating companies. For example, selective capitalization at the time costs are incurred (third alternative) might be determined to be appropriate for established operating companies, whereas accumulation of certain costs in a special category until a determination could be made as to whether future benefits exist (fourth alternative) might be determined to be appropriate for companies in the development stage.

(2) DIFFERENT PRIMARY FINANCIAL STATEMENTS

65 The differences between established operating companies and companies in the development stage may be considered so fundamental that special primary financial statements are required for companies in the development stage. For example, the AICPA Committee concluded that because of the absence of revenues a conventional income statement is inappropriate for a development stage company; special financial statements are necessary in order to emphasize accountability for financial resources received and expended and to direct attention to accumulated costs rather than to measurement of performance. To accomplish these objectives, the Committee recommended the following special statements:

Preoperating accountability statement— to show the assets and cumulative cost outlays, the liabilities, and the investment by stockholders.

Statement of preoperating financial activities— to show the sources and uses of financial resources, preferably cumulative since a company's inception along with data for the current period.

Statement of investment by stockholders— to show the classes and numbers of shares authorized, issued, and outstanding and the types and amounts of consideration received for the shares issued.

66 As mentioned earlier, Article 5A of Regulation S-X of the Securities and Exchange Commission calls for the following special statements of "commercial, industrial and mining companies in the promotional, exploratory, or development stage" to be filed as a part of registration statements and annual reports filed with the SEC.

Statement of assets and unrecovered promotional, exploratory, and development costs

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Statement of liabilities

Statement of capital shares

Statement of other securities

Statement of cash receipts and disbursements

The AICPA Committee recommended that any revenue earned by a company during the development stage should be deducted from the accumulated costs shown in the preoperating accountability statement. The Committee also recommended extensive disclosures emphasizing that the company is in the development stage, calling attention to the uncertainties that surround such a company and making clear that the financial statements do not present financial position and results of operations.[15]

The set of financial statements provided by the Committee for a hypothetical company is reproduced in Appendix E. In the Preoperating Accountability Statement included in this set of illustrative statements, "Cumulative Outlays" for "research and development" and for "preoperating costs for administration, market planning and organizational activities and interest" are listed along with cash and marketable securities, inventories and prepayments, and liabilities in order to account for the net investment by stockholders.

One member of the AICPA Committee advocated an alternative approach. He would show "cost outlays . . . for such items as research and development and for preoperating activities involving administrative, marketing and organizational effort" as deductions from the stockholders investment during the development stage. This latter approach is based on the premise that cost outlays should not be shown with "a company's separable resources and property rights which have intrinsic asset values by reason of generally possessing some alternative usefulness should the development activity prove to be unsuccessful." Once a company has reached the operating stage, retroactive capitalization of some recoverable research and development costs might be appropriate.[16]

Another set of primary financial statements for companies in the development stage has been suggested that would include:

Statement of monetary assets; property, plant, and equipment, deferred costs, liabilities, and equities

Statements showing changes in various kinds of deferred costs

Statement of cash receipts and disbursements

In the first of these statements, deferred costs would be segregated to show (i) deferrals of those costs that would be properly treated as expenses if incurred by an established operating company and (ii) deferrals of those costs that would also be properly deferred if incurred by an established operating company (e.g., certain research and development costs). Until operating status was attained, any revenues would be applied on a cost recovery basis to those deferred costs that would have been properly treated as expenses, if incurred by an

established operating company. Periodic assessments of all deferred costs would be necessary in order to determine whether elimination from the deferred cost status was appropriate. Depreciation and amortization would commence with the attainment of operating status. Throughout, these financial statements would be carefully designed to avoid the possibility that they might be interpreted as presenting earnings or financial position in the conventional manner for established operating companies.

(3) SPECIAL DISCLOSURES

72 Regardless of whether different accounting treatments are required for established operating companies and for companies in the development stage, or whether different primary financial statements are considered to be appropriate, the differences between the two types of companies may warrant special disclosures for development stage companies.

73 Special disclosures that might be appropriate in financial statements for companies in the development stage that are not generally provided by established operating companies are discussed below, together with arguments for and against such disclosures.

(a) Distinctive headings for financial statements

(b) A statement of cash receipts and disbursements

(c) Disclosure of development activities

(d) Disclosure of any planned additional capital requirements

(e) Forecasts

(f) Disclosure of liquidation values of assets and priorities to the proceeds from liquidation

(g) Descriptions of the business environment

(a) Distinctive Headings for Financial Statements

74 Supporting Arguments. Some individuals recognize that development stage companies are different from established operating companies but do not believe that the differences warrant different accounting standards. They might argue that the only special disclosure necessary for companies in the development stage concerns the headings to the financial statements. Statement headings which include a notation such as "A Development Stage Company" or "A Company in the Development Stage" would be sufficient to alert users to consider the differences between the company issuing the statements and an established operating company.

75 The differences between companies in the development stage and established operating companies have been discussed earlier. Whether a distinctive heading is sufficient disclosure depends upon the significance attached to those differences.

Opposing Arguments. A position may be taken that the kinds of differences that exist between established operating companies as a class and companies in the development stage as a class have no greater economic significance to investors than the kinds of differences that exist among individual companies within either class of companies. Accordingly, any attempts to call attention to the status of a company in the development stage as though that placed a company in a unique and homogeneous category are spurious and should be resisted.

(b) A Statement of Cash Receipts and Disbursements

Supporting Arguments. The ability to meet cash needs is a critical consideration for any firm, but especially for companies in the development stage. In addition, some feel that a primary objective of financial statements for development stage companies is to report on the stewardship of the invested resources. A statement of past and/or budgeted cash receipts and disbursements may be one method of supplying the information necessary to evaluate these requirements. Inclusion of such information on a cumulative basis might also be useful. Indeed, special primary financial statements which include these disclosures might be considered to be appropriate for companies in the development stage.

Opposing Arguments. The statement of changes in financial position currently required for all companies is adequate for any peculiar needs of investors in companies in the development stage; no special disclosure is necessary. It would be better to improve the presentation and understanding of the existing statement for all companies than to require a different statement for a few companies.

(c) Disclosure of Development Activities

Supporting Arguments. Some users argue that the most important information needed to evaluate the potential of a company in the development stage concerns the status of and prospects for individual research and development projects. Their argument states that the success of a development stage company is tied so closely to the success of development projects that failure to disclose this information severely limits a user's ability to evaluate the company's future.

A number of possible disclosures about the research and development activities of established operating companies were described and discussed in the preceding chapter. Presumably, one or more of those disclosures might be considered essential for companies in the development stage, whether or not they were considered appropriate for established operating companies.

Opposing Arguments. The special disclosures considered in the preceding chapter have certain implications for the established operating companies that would provide such information. The possibility of revealing competitive information, the burden of providing information not readily available, and the lack of objectivity in certain proposed disclosures were discussed there. The same implications are relevant in considering similar disclosures for companies in the development stage.

Excerpts from Exhibit F to Affidavit of Laura Banfield

FASB, Proposed Statement of Financial Accounting Standards: *Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components* (July 19, 1974)

EXPOSURE DRAFT

July 19, 1974

Proposed Statement of Financial Accounting Standards

Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components

THIS EXPOSURE DRAFT OF A PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS IS ISSUED BY THE BOARD FOR PUBLIC COMMENT.

Comments should be submitted in writing, received by September 30, 1974 and addressed to:

Director of Administration
File Reference 1027
Financial Accounting Standards Board
High Ridge Park, Stamford, Conn. 06905

Financial Accounting Standards Board

Additional copies of this Exposure Draft are available on request in reasonable quantities without charge from:

Director of Administration
File Reference 1027
Financial Accounting Standards Board
High Ridge Park
Stamford, Conn. 06905

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Proposed Statement of Financial Accounting Standards

Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components

INTRODUCTION

1. Companies deemed to be in the development stage have adopted various methods of accounting, forms of financial statement presentation and types of disclosure which, in many cases, are different from those used by established operating companies. Some of the special financial accounting and reporting practices followed by companies in the development stage have resulted from the application of regulations of the Securities and Exchange Commission and the use of special forms prescribed by it; other practices appear simply to have evolved over time. Special accounting practices include deferral of preoperating costs (sometimes including general and administrative costs and interest costs), non-assignment of dollar amounts to shares of stock issued for consideration other than cash and offset of revenues against deferred costs. Also, some development stage companies have adopted special financial reporting formats – for example, presentation of a balance sheet and a statement of cash receipts and disbursements or presentation of statements of (a) assets and unrecovered preoperating costs, (b) liabilities, (c) capital shares and (d) cash receipts and disbursements. Sometimes, a statement of operations is also presented.[1]

2. Special standards of accounting and reporting were not established for companies in the development stage by the AICPA Accounting Principles Board or its predecessor, the Committee on Accounting Procedure. In 1973, the AICPA Committee on Companies in the Development Stage issued an exposure draft of a proposed audit guide recommending special financial statements and accounting methods, but no action was taken on the exposure draft and the matter was referred to the FASB.

3. An established operating company may have a subsidiary, division or other component which is in the development stage. Such components have, at times, adopted the special accounting practices followed by companies in the development stage. The regulations of the SEC referred to earlier do not apply to development stage components. Such

[1] All footnotes appear on page 15.

components were similarly excluded from the proposed AICPA audit guide. The standards of financial accounting and reporting set forth in this FASB Statement shall apply to a development stage subsidiary, division or other component of an established operating company as well as to a separate development stage company (and to a group of companies which, as a whole, is considered to be in the development stage). Hereafter in this Statement, the term "company in the development stage" will be used to include a development stage subsidiary, division or other component of an established operating company. This Statement shall apply to companies in the development stage in all industries.

4. This Statement specifies the guidelines for identifying a company in the development stage and the standards of financial accounting and reporting which shall be applicable to such a company. Changes in certain accounting and reporting practices presently followed by some companies in the development stage will be required.

5. This Statement does not supersede, alter or amend any existing APB Opinion, Accounting Research Bulletin or FASB Statement of Financial Accounting Standards.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

6. The Board's determination as to the standards of financial accounting and reporting for companies in the development stage is set forth in paragraphs 7-16. The basis for these conclusions, as well as alternatives considered by the Board and reasons for their rejection, are discussed in Appendix B.

Guidelines for Identifying a Company in the Development Stage

7. For purposes of this Statement, a company shall be considered to be in the development stage if either of the following conditions exists:

a) It is devoting substantially all of its efforts to establishing a new business and has not commenced its planned principal operations.

b) It has commenced its planned principal operations but has not had significant revenues therefrom.

8. In establishing a new business, a company in the development stage will typically be engaged in the following activities, among others: research and development;[2] financial planning; raising capital; establishing sources of

supply; acquiring property, plant, equipment or other operating assets; personnel recruitment and training; developing markets; and start-up of production.

Financial Accounting Standards

9. For the reasons expressed in paragraphs 24-35 of Appendix B, the Board concludes that *no special accounting standards shall apply during the development stage*.

10. In accordance with paragraph 9, a development stage company shall:

a) Charge to expense as incurred during the development stage those costs which will be charged to expense as incurred when the company is no longer in the development stage.

b) Capitalize or defer only those types of costs which may be capitalized or deferred subsequent to the development stage.

c) Report sales of goods or services, interest and other income as revenue in the income statement.

d) Assign dollar amounts to shares issued for non-cash consideration, and to the consideration received, at the time of issuance.[3]

e) Report cumulative net losses as "accumulated deficit" in the stockholders' equity section of the balance sheet.

Financial Statement Presentation and Disclosure

11. For the reasons expressed in paragraphs 36-41 of Appendix B, the Board concludes that a company in the development stage shall present the same primary financial statements as an established operating company but shall include therein certain additional information. Financial statements presented by a company in the development stage shall include the following:

a) A balance sheet.

b) An income statement, showing amounts of revenues and expenses for each period covered by the income statement and, in addition, cumulative amounts from the inception of the development stage.

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c) A statement of changes in financial position, showing the sources and uses of financial resources for each period covered by the statement and, in addition, amounts on a cumulative basis from the inception of the development stage.

d) A statement of owners' investment, showing from the inception of the development stage:[4]

1) The dates of each issuance and number of shares of stock (or warrants, rights or other equity securities) issued for cash and for other consideration. For each issuance, the nature of the consideration received, other than cash, shall be described.

2) The dollar amounts (per share and in total for each issuance) assigned to the consideration received for shares of stock (or warrants, rights or other equity securities) issued, and the basis for assigning dollar amounts to consideration other than cash.

12. The financial statements shall be identified as those of a company in the development stage.

13. The notes to the financial statements for the first fiscal year in which a company is no longer considered to be in the development stage shall disclose the fact that the company had, in prior years, been a development stage company. Financial statements for such prior years, if currently presented for comparative purposes, need not repeat the disclosure of cumulative amounts since inception or other special disclosures required by paragraphs 11-12.

EFFECTIVE DATE AND TRANSITION

14. The provisions of this Statement shall be effective for fiscal periods beginning on or after January 1, 1975, although earlier application is encouraged. Thereafter, when financial statements, and financial summaries and other data derived therefrom, are presented for periods prior to the effective date of this Statement, they shall be restated, where necessary, to conform to the provisions of this Statement. Accordingly, any previously capitalized or deferred costs which may not be capitalized or deferred by a company in the development stage (in accordance with paragraph 9) shall be accounted for as a prior period adjustment (as described in paragraphs 18 and 26 of *APB Opinion No. 9*).

15. Costs which had been capitalized or deferred prior to the effective

Excerpts from Exhibit F to Affidavit of Laura Banfield

EXPOSURE DRAFT

date of this Statement by a company which is now an established operating company but which was previously considered to have been in the development stage shall be accounted for as a prior period adjustment, and prior period financial statements shall be appropriately restated, if paragraph 9 of this Statement would not now permit capitalization or deferral of such costs. In some cases, only prior period financial statements will be affected and those statements shall be restated when they are included for comparative purposes with financial statements for periods after the effective date of this Statement.

16. The nature of any prior period adjustment or restatement resulting from application of paragraphs 14 and 15, and, where appropriate, its effect on income before extraordinary items, net income and related per share amounts, shall be disclosed in the period of change for all periods presented. The prior period adjustment shall recognize any related income tax effect.

The provisions of this Statement need not be applied to immaterial items.

fact he relied on those annual reports for his purchase, and the depositions show it.

THE COURT: What are the dates? Do you run through 1972?

MR. BADER: Oh, yes.

THE COURT: Into 1973?

MR. BADER: On that I do not have the interrogatory answer, but there are continuous purchases, and we have other people who bought the stock. There is no problem with respect to the date of the purchases of the stock--I think my adversary will concede that.

The problem then comes to the point about going back to the original prospectus: Was the company a company in the development stage at the time of the original prospectus?

Now the affidavit of Mr. Abramson, who is a man who is involved in research and patent problems, and was for a considerable number of years--it claims that this could not be considered a proper company in a development stage because of the statement which appears on page 3 of the prospectus.

THE COURT: Yes?

MR. BADER: And in the prospectus it says:

"The company incurred approximately $6,076,000

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of research and preoperating costs in developing its Cartrivision system."

Now if that were the only thing that they said, then perhaps this could be considered as a company in the development stage, but it goes further. It says:

"And it estimates that at least an additional $7,509,000 of preoperating costs must be incurred before the first units can be sold."

And then it says that it also requires an additional $8,640,000 "before the first units can be sold."

So that they must, according to their prospectus, have approximately $16 million in addition to the $6 million in order be able to get the first units sold.

Now, therefor, that could not be considered to be a company in a development stage. These research and preoperating costs are applicable to an abandoned experiment--just as if I was going to be developing an atomic energy engine for an automobile, and I spent $10 million on this, and so far I do not have anything, and I estimate that it will cost me an additional $100 million to be able to get something.

At that point--

THE COURT: I do not understand where you get this "abandoned experiment" characterization.

MR. BADER: Well, your Honor, let us suppose that I, right now, go ahead and try to develop something and I am unsuccessful.

THE COURT: Where does it say it was "unsuccessful"?

MR. BADER: It says that they require this large amount of additional capital before any units can be sold.

THE COURT: I know, but how does that make the other business unsuccessful?

MR. BADER: Because they have not accomplished anything.

THE COURT: How do you know they have not accomplished anything? It doesn't say they haven't accomplished anything. They say, "We have to do more work on this."

MR. BADER: But where the amount of work they have to do is more than twice the amount of what they already have, without having an operating prototype, then I submit to your Honor that under these circumstances such deferrals would not be proper.

THE COURT: Why? Where does it say something in the law about abandoned experiments not making you a development company? At what point, when they were sticking those rods in whatever they were sticking them in at the University of Chicago, did they abandon the experiment and go on to

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something else? If it does not sound scientific, is it something else--

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MR. BADER: The answer to that question I just do not know.

THE COURT: Well, if you do not know --

MR. BADER: I just do not know.

THE COURT: But your affiant says it is, as though everybody knows it, and it doesn't sound correct to me. It is unsupported by any authority that is germane to a judge's task? How am I supposed to handle it?

MR. BADER: Well, that is the problem we have in this entire case. As a matter of fact, if you go along with Judge MacMahon's theory, as he discussed it in one case that I cite in my memorandum, it doesn't make any difference whether or not this was done in accordance with sound accounting practice if in fact this prospectus was misleading, and if it mislead purchasers of stock, even if the accounting was absolutely correct, it would still be misleading and it still would be actionable.

THE COURT: Now you are on another subject.

MR. BADER: Well, that is right.

THE COURT: You did not like the subject we were on?

MR. BADER: No, I like the subject we were on.

THE COURT: Then why don't you stay on it?

MR. BADER: All right.

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THE COURT: So that I can understand what you mean.

MR. BADER: I say this, your Honor, I say that a company is in the development stage if it has expended an amount of money to develop something, and where it has some tangible results for its development -- not where it has got to spend at least twice as much --

THE COURT: I know you say that but with all deference to you, who else ever said it?

MR. BADER: Mr. Abramson said it.

THE COURT: Who else ever said it that makes it in any way persuasive to me as a District Judge? That is what I am asking you. You may say anything and I would listen to you but at some point I would ask you if you and I say this and somebody more learned looks at this, will he believe it?

MR. BADER: In other words, you are saying would an accountant say that -- is that what you are saying?

THE COURT: Yes, that is one of the things I am saying.

MR. BADER: May I submit an additional affidavit of Mr. Reid who will say that.

THE COURT: No, of course not. We can all get experts to make affidavits, with all respect to them.

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I mean, did anybody say it in a book, in a generally significant place, not made or created for purposes of litigation?

MR. BADER: Oh, in other words, what you are asking me, your Honor, is do I know of any authority in the accounting profession that says this.

THE COURT: Or in the legal profession.

MR. BADER: Or in the legal profession.

THE COURT: I even look at legal authorities!

MR. BADER: And if I may say to your Honor, the answer is "No".

THE COURT: Well let me tell you that my answer is I cannot make use of your newly-minted conception, because it does not make sense to me, and that is all I have to use.

All right; you are both agreed on the question of security, the standard that I should apply, and I will, on the basis of what you both say, go back and look over this and see whether Mr. Thompson could have been misled and whether he was, and whether there is an issue of fact about that, and I will decide that.

MR. BADER: Thank you.

THE COURT: Do you want to say anything in rebuttal, Miss Banfield?

Excerpts from Examination Before Trial
of Plaintiff Eddie L. Thompson, Jr. by
Defendant Arthur Young & Company

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EDDIE L. THOMPSON,

called as a witness, being first duly sworn, testified as follows:

EXAMINATION BY

MRS. BANFIELD:

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Q Mr. Thompson, are you a plaintiff in this action?

A I am.

Q Where do you reside, sir?

A Inman, South Carolina.

Q Do you have a street address?

A Laurel Hill Subdivision.

Q Do you have a place of business?

A Business, 17 North Main Street.

Q In Inman, South Carolina?

A Yes.

Q Do you have any other place of business?

A No.

Q This is a noisy and inconvenient room that we have to work in, sir, and for everybody down the line to hear you, we are all going to have to speak louder than we ordinarily do. It's very important that they are able to hear you as well as the reporter.

* * * *

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Q At the public offering price?

A Yes.

Q Which I recall was $20 a share, is that about right?

A Yes.

Q And you bought 1,000 shares, I believe, is that correct?

A I believe I purchased at first 1,000 shares. I think that's correct.

Q When was the next purchase you made of Cartridge shares?

A According to these records that were furnished by Hornblower & Weeks, they are the correct dates. In the letter form I have.

Q So the next one would be on July 23, 1971?

A Well, without having that letter before me, I would have to state that I would have to refer back to the letter.

Q Okay, let's have you do that. On July 23, 1971, 700 shares?

A 700 shares.

Q What was the price you paid for those shares?

A $20 a share.

Q What led you to make that additional purchase?

A All the nice things that Hornblower & Weeks was saying about the stock and being touted from every direction in that office. And just telling me I had to do these things, it was going to be a great stock.

Q What had the price of the stock done between July 13 and July 23?

MR. BADER: Objected to as irrelevant, incompetent and immaterial and I instruct the witness not to answer. The record speaks for itself.

Don't answer that question.

Q Who in the Hornblower office was touting this stock that you recall?

A From the top down. Everyone.

Q Specifically with respect to the 700 shares that you purchased on July 23, 1971, was there any particular conversation that you had which led to that purchase?

A Specifically to all purchases from Hornblower & Weeks.

Q No, I just asked about that specific

* * * *

to the Young claim.

MRS. BANFIELD: Mr. Bader, I am examining on behalf of defendant Arthur Young & Company. I am asking questions which I consider highly material to the claims against Arthur Young and its defenses in this action and I will proceed and if you object --

MR. BADER: Fine.

MRS. BANFIELD: Then I will know what I need a ruling on.

MR. BADER: Then I will know what I need to do.

Q On September 9, 1971, did you buy some more Cartridge stock?

A September 1?

Q September 1 or September 9, what does it --

MR. BADER: September 7.

Q Excuse me, September 7, according to Hornblower's letter to you, you bought another 1500 shares of Cartridge stock, is that correct?

A That's right.

Q At what price?

A 19-3/4.

Q What was the basis, what led you to make

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that transaction?

A The same as I have given before.

Q Conversations with Hornblower?

A Yes.

Q At that time, sir, had you seen a final prospectus of Cartridge Television?

A It had been mailed to me, yes.

Q Do you have that any longer in your files?

A No.

Q Did you throw it out?

A I assume.

Q You didn't keep it anyway for future reference?

A No.

Q Other than the preliminary prospectus which you inspected at Cartridge's office and the final prospectus that was mailed to you, did you, as of September 1971, have any other documentation about Cartridge?

A Well, I don't know. There were a lot of releases came, interoffice releases with Hornblower that could very well be in the files. I would say they began very early to make releases on all

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told him to sell me out.

Q And he did?

A And he did.

Q When you were sold out at the end of that day, what price did you sell out at?

A They tried to give me 33 and I said that's not right. It went down to 33 and I said that's not correct. I tried to sell at 39. I said I'm not taking that price. They gave me the closing price of $35.50 a share.

Q The closing price at what day?

A That day. They tried to confirm it at $33 to me.

Q On the basis of the price you actually got out at the close of that day, taking the price that you paid for all of your Cartridge shares, your Cartridge position and the price you paid when you sold it, were you ahead or behind?

A I was ahead.

Q Did you have a profit?

A I did.

Q How much of a profit?

A Well, it speaks for itself. The sales I bought under. I don't know exactly.

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Q It's over $60,000, isn't it?

A Approximately.

A February 2, '72, I purchased 1000 shares.

Q At what price?

A 40-5/8.

Q Now, between the time, the day January 24, when you got out of Cartridge, and February 1, 1972, when you bought another 1000 shares through Hornblower, did you have any conversations with anybody at Hornblower about that stock?

A Yes.

MR. BADER: Objected to on the ground it does not involve the Arthur Young claim and I instruct the witness not to answer.

MR. BANFIELD: Let the record show that the witness answered the question in the affirmative.

Q Did you receive any reports or writings from Hornblower during that week.

A No, I have no -- anything in writing from Hornblower except the wires that constitutes anything other than conversation from Hornblower.

Q Had you seen any financial statements of Cartridge during that week?

A No.

Q So your decision to go back into Cartridge to buy the shares on February 1st was not based on

financial statements which you saw during that period?

A On the financial that I saw, the original recommendation of Hornblower & Weeks kept me in Cartridge Television.

Q Again, I would like to go back and see if I can get an answer to the question I asked. Which is whether you saw any financial statements of Cartridge during the week between the time you sold out and the time you bought back?

A I don't even know they were available at that time.

Q The answer to the question is no?

A It would have to be no.

Q Next question is, on what basis did you go back into Cartridge?

A This involved Hornblower.

Q That's all right. You just tell me --

MR. BADER: I instruct the witness not to answer. In view of that remark, I am going to instruct the witness not to answer. It does not involve an Arthur Young claim.

MR. BANFIELD: Mr. Bader, would you be prepared to stipulate that any purchases of Cartridge

stock which Mr. Thompson made on the basis of contacts with Hornblower are not contended by you to be a basis for your claim against Arthur Young?

MR. BADER: That's not so at all.

MR. BANFIELD: Then let me get answers to my questions.

MR. BADER: All right, I will withdraw the objection. In view of that colloquy, I think you got a point of relevancy. And I think we should go ahead.

MR. BANFIELD: Let's have the question again.

(Question read)

MR. BADER: You may answer that.

A Hornblower & Weeks' recommendation.

Q Nothing else?

A Correct.

Q When did you next purchase Cartridge stock?

A 3/17/72, Ipurchased 200 shares at 37-1/2. Hornblower & Weeks.

Q Through Hornblower & Weeks as the broker?

A Correct.

Q On what basis did you purchase those

shares?

A Same recommendation from them that I made a mistake to sell out, I should buy more back.

Q You followed their instruction?

A I did.

Q Did you see any announcements concerning Cartridge or reports that influenced your judgment?

A No, but I asked them to call each time to New York and get the information on what they thought -- what the New York office thought the Cartridge stock would do,how it would perform and should it be a good buy at that point.

Q Do you remember your conversations which led to the purchase of stock on March 17, 1972?

A Virtually all of my answers are the same, that they recommended it strongly and I do not -- I could not roll the clock back that far to specifically remember exact words. It would be unfair to state that against Mr. Trakas.

Q You don't remember anything specific he told you, then?

A Let me say, as I was cut off several times, their recommendations in all cases was for me to buy, I would make a lot of money. I

about your purchases and sales of Cartridge stock and I'd like to continue where we left off.

I believe we were about ready to start with July 17, 1972. From your answers to AVCO's interrogatories, which are Defendant's Exhibit 3, and the letter you received from Hornblower, Weeks, which is Defendant's Exhibit 4, can you tell me whether you purchased shares of Cartridge on or about July 17, 1972?

A Yes.

Q Did you?

A Yes.

Q How many shares did you purchase at that time?

A It shows here 500.

Q What was the price per share for those that you purchased for those shares?

A 26-3/4.

Q And the total price that you paid?

A $13,375.

Q What led to the purchase of those shares?

A Encouragement of Hornblower, Weeks and the original information that I had received.

this point.

(Record read)

A Again, I state on the recommendations of Hornblower, Weeks, no specific --

Q The answer is, you do not recall a specific conversation with Hornblower in which they recommended that you purchase those shares?

A My specific is that, on these occasions, each and every date, I could not remember. No one would be able to.

Q Then the answer to my question is no, you do not recall a specific conversation with Hornblower which led to the purchase of those shares?

MR. BADER: That is not the answer. You are suggesting --

MRS. BANFIELD: Mr. Bader, will you please be quiet and let the witness answer the question.

MR. BADER: I certainly object to your suggesting an answer to the witness which does not accord with the facts.

Q Do you recall a specific conversation which led to your purchase of those shares?

A My specifics are the recommendations entirely.

Excerpts from E.B.T. of Plaintiff Eddie L. Thompson, Jr.

Q No, Mr. Thompson, once again, it's a narrow question and it is specifically directed to whether you recall at this time sitting here today a specific, one particular conversation that you had with somebody which led you to buy those shares.

A I could not state that.

Q All right, that's all I wanted to know.

MRS. BANFIELD: I have a document here which is among those produced by the plaintiffs. It seems to be cut off a bit on the left-hand side. I will describe it for the record from what I can read. "Public-branch and home ofc distribute research flash dated 6/13/1972 on Cartridge T. V."

I will ask that the reporter mark that as Defendant Arthur Young's Exhibit 22 for identification, please.

(Document marked Defendant Arthur Young Exhibit 22 for identification)

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Q Have you ever seen that document before, Mr. Thompson?

A It's so much cut off here, I don't know that I have but I will say that it's possible.

Q It's possible? Are you guessing now?

* * * *

Q What information did he give you that led you to purchase Cartridge shares on September 1, 1972?

A Again, I repeat the the stock was going to be a real good buy, it was going up and I should purchase in all cases.

Q Was the stock going up at that time, sir?

A I believe it was above the purchase I made on June 26th.

Q Was it up from February 1, 1972?

MR. BADER: You mean February 21, 1972?

MRS. BANFIELD: I mean February 1, 1972.

MR. BADER: All right.

A No, it was below at that time.

Q Speaking specifically now about the purchase of Cartridge shares that you made on September 1, 1972, were those shares purchased on your initiative?

A All the shares of Cartridge Television --

Q Mr. Thompson, if I can stop you. I am asking you about the specific purchase that you made on September 1, 1972.

A Any purchases made by any stockman that he is buying from his broker on a recommendation, whether it is of his own at the time or whether he is

encouraged to. In this case I answer all cases I was encouraged to buy Cartridge Television stock.

Q You said you went into Hornblower's office, is that correct?

A I said that, correct.

Q Did you ask Mr. Trakas, should I buy some more Cartridge?

A I never walked in and asked him. I walked in and discussed the market with him, reviewed it. In such a case, a recommendation would come forward.

If I had an occasion to purchase stock, in all cases, I asked an opinion, which came from his New York office.

Q Did you ask Mr. Trakas on the occasion of your purchase of Cartridge shares on September 1, 1972, whether you should purchase more Cartridge?

A I in no case asked him. I would be encouraged to buy.

Q He brought the subject up and not you?

A In each and every case.

Q At that time you held quite a few shares of Cartridge, isn't that correct?

A That is correct.

Q Was it your practice to go into his office

and check up on how that investment was doing?

A Correct.

Q So you would go into his office and ask him, how was Cartridge?

A Walk in and push it out on the machine. He would invite me into his office.

MR. BADER: Mrs. Banfield, will you please tell me what the relevancy of this line of questioning is with respect to the Arthur Young claim?

MRS. BANFIELD: Not in front of the witness, Mr. Bader.

MR. BADER: If you feel that way about it, then if I feel something is irrelevant, I am going to instruct him not to answer.

Q Was that purchase of Cartridge shares on September 1, 1972, the last purchase of Cartridge that you made through Hornblower?

A September when?

Q September 1, 1972.

A That is correct.

Q After that, you didn't do any more business in Cartridge through Hornblower, is that correct?

A Correct.

Q Do you still have an account with Hornblower?

Q So you bought that 2,000 shares after you knew that the company was going to file in re-organization?

A Yes.

Q For what purpose did you buy those 2,000 shares?

A Well, everyone at one time or another thinks that 50 cent stock might look good. I guess you can call it a little bit of crap shooting when I got that far down the line.

Q Would you say the same thing with respect to your purchases in August and October of 1973?

A In August?

Oh, yes.

Q That was crap shooting too?

A Sure.

Q What about back in May of '73?

A Still had hope.

Q. Even after it was announced that they laid off 300 employees?

A Yes. I was very close and discussed this to the extent that I felt like that the concept that it was a great thing for the future and it

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would in some way come back. I knew at that time I was in trouble but I thought it still had a chance.

MRS. BANFIELD: Do you want to read that answer back, please.

(Answer read)

Q In that answer, sir, you said you were close. Close to what, to whom?

A Mr. Dempsey for one.

Q Anybody else?

A He was the man that I talked extensively with. Made numerous trips around the country trying to help raise the money to reorganize the company.

Q Anybody besides Mr. Dempsey --

A Mr. Dempsey was the one nearest. I discussed it with Mr. Stanton, yes. Mr. Stanton furnished me the papers about it, carried around to try to reorganize with.

Q When did you first meet Mr. Dempsey -- I tell you what, before we get into a whole new topic, it's twenty of 1:00. I will put the documents away and we will break. Suppose we reconvene here at 1:30. Is that acceptable?

MR. EADER: That's fine.

Television, Inc. was marked Defendant Arthur Young Exhibit 34 for identification)

Q Have you seen that document before, sir?

A Yes. I have seen an annual report. Maybe not this one.

Q Did you provide a copy of the annual report to your counsel, the '71 annual report for use in this case?

A Yes.

Q You did?

A Yes.

Q From whom did you receive that report?

A Hornblower, Weeks.

Q When did you get it?

A I would say shortly after it came out but I do not know to the date.

MR. BADER: Let's see if we can figure out when it came out.

MRS. BANFIELD: Mr. Bader, I am proceeding along. I don't need that --

THE WITNES: I don't know the mailing dates that it reached me at that particular time.

Q Did Hornblower mail it to you?

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A I'm not sure, they might have handed me that report.

Q Did you read it?

A Did I read it?

Q Yes.

A Yes, sir.

Q Did you read the financial statements in it?

A I did.

Q And the report of Arthur Young on those financial statements?

A Yes.

Q How long did you spend reading it?

A I spent considerable time at this time. Studying it and see the best I could as one not really qualified in the financial field, to see what I thought about what the company was doing. And to see if I thought it was still a company that was solvent.

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MRS. BANFIELD: Would you read that answer back, please.

(Answer read.)

Q Did you read it on more than one occasion?

A Oh, yes.

Q About on how many occasions?

A Well, I am a bathroom reader. I read it quite often, if you will pardon the expression.

Q Did you keep it in the bathroom or put it in your file?

A Kept it in my bathroom. I don't maintain a file on stocks.

Q Incidentally, did you also -- have you ever seen a copy of the 1972 annual report of Cartridge?

A Yes.

Q Did you produce that to your counsel?

A I produced it to my accountant in Spartanburg for study.

Q What is his name?

A Lowell M. Reed. Which will be brought into this matter.

Q Have you given him the 1971 annual report?

A I have. And a copy of the prospectus.

Q Did you give those to him at the same time --

strike that -- when did you give the prospectus and the 1971 annual report to Mr. Reed?

A Mr. Reed has been given that of recent, very recent.

Q Since after the filing of this lawsuit, is that correct?

A Right.

MR. BADER: I just wanted to say for the record, Mrs. Banfield, that I was unaware of Mr. Reed's existence until Mr. --

MRS. BANFIELD: Mr. Bader, this isn't --

MR. BADER: That's not in your answers to interrogatories and I want to make clear that --

MRS. BANFIELD: I will get to that when I am ready to get to it.

MR. BADER: Okay.

Q The 1972 annual report, from whom did you receive that?

A I would say the '72 came to me through the same source of Hornblower. I do not recall whether it was mailed to me or they gave it to me but I would think they gave it to me.

Q Did you read it when you got it?

A Yes, for the same purpose.

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Q I believe you said that you then gave it to Mr. Reed?

A Oh, no. Not until recently.

Q Not until recently?

A Yes.

Q Since the filing of this lawsuit?

A Since the filing. Within the last week.

Q When you got the 1972 annual report, did you discuss it with anyone?

A No.

Q No?

A No.

MR. BADER: You are talking about prior to this lawsuit, I take it?

MRS. BANFIELD: Yes.

Q When you got the 1971 annual report, excuse me -- the 1972 annual report, did you discuss it with anyone?

A No.

Q The answer is no?

A No.

MR. BADER: Prior to this lawsuit?

Q When you got the 1971 annual report, did you discuss it with anyone?

A No.

MR. BADER: It being understood, let the record show it is being understood you are talking about discussions prior to the institution of this lawsuit.

THE WITNESS: That is correct.

Q In speaking of the 1971 annual report, I believe you said that you read it as one not qualified in the financial field, is that correct?

A I don't feel I'm qualified to follow all the company financial backgrounds that you or other people have. I am not qualified, I don't believe.

Q Did you feel when you got the '71 annual report and you looked at the financial statements in that report, that you were qualified to interpret those?

A I would not know by qualifications but I thought in all cases that I was still in a company that was solvent as it was so indicated. The referrals and a lot of things in there which I really didn't understand but I read the balance sheet and to me the company -- obviously, I thought, had solvency or I would not have purchased other stocks.

Q Was there a balance sheet in the 1972

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financial statement?

A I do not recall.

MR. BADER: 1972 or are you talking about '71?

A I studied in each case the best to my ability the financial matters that I thought was related to the operation of the company and whether or not that had a balance sheet, I would not make that statement at this time.

Q Are you familiar with the 10K report?

A I never saw a 10K report. I have heard of them.

Q You know what they are?

A Yes, I do now.

Q But you didn't know before this lawsuit was started, did you?

A No.

Q And you never saw a 10K on Cartridge?

A No.

Q Either for '71 or '72?

A Did not.

MR. BADER: Are you through with the '71 report?

MRS. BANFIELD: Yes. For the time being.

* * * *

Excerpts from E.B.T. of Plaintiff Eddie L. Thompson, Jr.

MR. DANIELS: Mr. Bader, I think we are not only entitled to it, I think we have been entitled to it for quite some time. I am totally flabbergasted a document production can occur without the client participatign therein.

THE WITNESS: I take error in that, that I thought when I produced these letters from each individual, that I was supplying to you to substantiate that part of it. That is the part that I take the blame for, upon Mr. Bader. I had those letters prepared and signed by each firm and I thought that was -- would suffice. That is why those letters were made, the transactions.

MR. DANIELS: But you now understand the error of your ways, so to speak, and you are willing to return home and correct --

THE WITNESS: I am willing in all fairness to this Court.

Q Now we go back to Defendant Arthur Young's Exhibit 40 for identification. Did you receive that letter from Mr. Bader on or about February 1, 1974?

A I would say shortly after that.

Q In your answers to Defendant AVCO's interrogatories, sir, on page 17, you state that

Excerpts from E.B.T. of Plaintiff Eddie L. Thompson, Jr.

approximately February 1974, after having received a communication from general counsel of the Independent Investor Protective League, I made an appointment and met with such general counsel in New York.

Is the letter which has been marked Defendant's Exhibit 40 the communication to which -- the communication from the general counsel which you referred to?

A That is.

Q Did you also receive any telephone call from the Independent Investor Protective League?

A I received this letter to the best of my knowledge and then I called Mr. Bader and made an appointment to come to New York so see him.

Q Prior to that time, had you ever discussed with anyone whether the financial reports of Cartridge, upon which Arthur Young reported in the prospectus, or the '71 or '72 annual reports had been misleading?

A Prior to that I was totally in the dark. I had discussed it with no one.

Q The first time you discussed it with anyone was with Mr. Bader?

A That is correct.

Q Is it fair to say, sir, that you brought your claim against Arthur Young in this action

based upon what Mr. Bader told you?

A Based upon the information supplied by counsel.

Q What information was that, sir?

A The misleading information that was pointed out to me in the prospectus and in the company annuals.

Q Who pointed it out to you?

A Mr. Bader.

Q Did he suggest that a claim be brought against Arthur Young?

A No. I myself was pursuing some recourse for recoveries here. That was the purpose of all of my correspondence. He did not suggest it.

Q But prior to the time you met with him, had you considered a suit against Arthur Young?

A I had considered, ever since I returned from San Jose, California, recourse but I didn't know of what nature.

Q Or against whom?

A The total of Cartridge Television, whichever and wherever it was felt. After I had extensively tried to help bring this company back and no meetings were supplied me, and with the amount of monies that I had involved, I felt that I had to,

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as any man would, look into the situation to see if it was clean and clear and if I had to live with it or if I had recourse to recovery but I did not discuss it with anyone.

It is something I lived with and deliberated with myself.

Q Specifically did you deliberate with yourself about suing Arthur Young?

A Whoever, as I deliberated, whoever I found or thought that this dilemma laid with, would be the course of action I would take.

MRS. BANFIELD: Would you read that answer back, please.

(Answer read.)

Q Was Mr. Bader the first person who suggested to you that the dilemma laid with Arthur Young?

A Mr. Bader pointed out the facts of this case to me. Did not suggest that I bring suit against you or anyone. He only pointed out what I saw and gave me time to study of it and look at it and I instructed him to go forward with it.

Q When you first wrote to the League, you inquired, did you not, as to who there -- what they could tell you about a Securities and Exchange

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MR. BADER: Let the record show that Mr. Williamson is not here, that we did attempt, at least Mr. Horgan did attempt to telephone him and I understand from Mr. Horgan that his secretary said he planned to be here but has not yet arrived.

E D D I E L. T H O M P S O N, having been previously duly sworn, testified further as follows:

EXAMINATION BY

MRS. BANFIELD:

Q Mr. Thompson, I think we have established by now that you bought some Cartridge Television stock in the initial public offering of Cartridge, is that correct?

A Right.

Q And that offering took place on July 13, 1971

MR. BADER: If that's the date.

A That's the date, I believe.

Q And I believe we also had some testimony that prior to that offering you had seen a preliminary prospectus of Cartridge Television, is that correct?

A Yes.

Q Do you know the date of the preliminary prospectus that you saw?

A I do not.

Q Did you see more than one?

A No.

Q I'd like to try an experiment which may or may not be fruitful. I'm going to show you several and see by looking through them, you can pick out for us the one you actually saw?

A The one I saw was at Gus Trakas' office, Spartanburg office, and I could not identify it by any display you may have as to which one it was.

Q You don't think, for example, by particular numbers which you might remember, that you would know?

A Certainly not.

MR. BADER: Maybe you ought to try anyway.

MRS. BANFIELD: I don't want to try Mr. Thompson's patience beyond bearing.

THE WITNESS: Let me say that I saw a prospectus that was supposed to be a preliminary prospectus. That I did look and read it. But to identify one that you would have here, there may have been numerous ones, I think it would be unfair to say I could identify it as to which one.

Q When you read it, were you with Mr. Trakas?

A Pardon?

Q When you read it, were you with Mr. Trakas?

A Yes.

Q I believe you said the other day you and he looked through it together?

A Right.

Q On one occasion, sir?

A Yes.

MR. BADER: Wait a minute, we have to fix that point in time. Are we talking about the prospectus or the preliminary prospectus?

MRS. BANFIELD: Mr. Bader, I will examine the witness. If you want to cross examine the witness --

MR. BADER: It isn't a question of cross examining. I want to know whether this series of questions involve the preliminary prospectus or the --

MRS. BANFIELD: So far, sir, they involve the preliminary prospectus.

Q We don't know the date on which you and Mr. Trakas looked at this prospectus?

A Prior to my purchase.

Q We don't know whether it was in March?

A No.

Q Or April?

A I could not say. I think I have established that.

Q I think so too.

Q I believe you said you later got a final prospectus in the mail?

A Correct.

Q This is after the public offering, is that right?

A Yes.

Q A few days later?

A It was either-- I could not say it was -- no, they mail those out. As to the purchase, hour or timing to that arrival there, I could not say.

Q Sure, I understand that. But in any case, when you got it in the mail, you had already bought your shares?

A I do not know -- I think that that would be possible to say. You would say that Hornblower, Weeks did mail me a prospectus.

Q When you got the final prospectus, did you have occasion to go through that too?

A I looked through it, yes.

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Q Were you with anybody?

A Was I with anyone?

Q Did you look through it --

A I carried it home, as I told you before. I read it on occasions.

Q Would you say you spent as much time looking at that one as you had at the preliminary one?

A I would say yes.

Q I believe you said you do not keep a file on stocks?

A No.

Q So where did you keep this final prospectus?

A The final prospectus, I carried it around in my car some. I do most of my reading, as stated, in my bathroom. So again it would be fair to say that's where I did part of my study.

Q Do you keep a lot of prospectuses in the bathroom?

A I keep it until it gets where I have to throw it out and burn it. Not a lot of prospectuses, let me rephrase that.

Reading material.

* * * *

witness goes forward and answers the question.

MR. BADER: I will object to the question on the ground it calls for ultimate fact involved in this case which must be determined eventually by a jury and therefore, I say the question is improper and I will instruct the witness not to answer.

Q Are you an accountant, Mr. Thompson?

A I am not.

Q Do you consider yourself when it comes to reading financial statements in a prospectus an ordinary investor?

A I would say that I am not of the superior type analyzing any financial statement.

Q Well, I'm going to show you a copy of the July 13, 1971 prospectus of Cartridge. This happens to be one that -- the one that was marked Defendant Arthur Young's Exhibit 31 for identification, but the fact that it's this particular copy, it's not significant.

A But you are stating that is a copy that was used?

Q That's right. I am going to ask you about the first occasion when you read a prospectus

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MRS. BANFIELD: Off the record.

(Discussion off the record)

MR. BADER: Let the record snow we are now in business and Exhibit 49 is the prospectus of July 13, 1971 and we will work from that. Perhaps you should -- since we have had such colloquy, perhaps you should rephrase the question.

Q I would like to have Mr. Thompson turn to the financial statements in the prospectus, please.

MR. BADER: Which ones?

MRS. BANFIELD: Mr. Bader, I will ask the questions, please.

MR. BADER: Don't you think you ought to refer him to a page number?

Q Have you got it, sir?

A Statements of assets, intangibles and deferrals.

MR. BADER: Page 22.

MRS. BANFIELD: Mr. Bader, I would very much appreciate your allowing me to conduct the examination.

Q What page are you looking at, sir?

A I am looking at page 22.

Q At what schedule are you looking at the

moment?

MR. BADER: I object to that question and instruct the witness not to answer.

MRS. BANFIELD: I withdraw the question, Mr. Bader.

Q When you first examined the prospectus of Cartridge with Mr. Trakas, was there anything in the financial statements which made a particular impression on you at that time?

A The fact that I thought it was a solid company. I knew it was a young company. I thought, as I looked at these figures, that it had some cash value to it.

Q What gave you that impression, sir?

A What gave you that impression?

Q Yes.

A Just looking at it.

Q Can you point to anything in particular that gave you that impression?

A The fact that it had -- it so indicated to me it had assets and that the monies that were going into the company would further that and -- with respect to the sales.

Q Looking at the statements that you see

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before you, the three statements on page 22, what statement shows assets?

A The assets here.

Q Do you want to read it --

MR. BADER: Maybe we should have them marked, don't you think --

MRS. BANFIELD: Mr. Bader, I would appreciate your letting me conduct this examination.

MR. BADER: I have no objection to letting you conduct this examination but the record doesn't show here or what you are pointing to and I think if we are going to have an examination, we are entitled to have a complete record.

MRS. BANFIELD: Mr. Thompson is going to tell me what statement shows the assets which Cartridge had and then when he does that, it will be on the record.

A The assets that I read were assets that showed the company and as far as the deferrals and things are footnoted, I did not understand it. I read this to be a company realizing that I was taking an interest in, that we were to put a million additional dollars with this and I did not question that it would be solvent, that it would own no monies

with this $20 million that was coming into the company and that -- as to the extent of what I took this to be along with what we were putting into the company, I say we as a stockholder.

Q Well, sir, --

A Again, I am not an accountant to read this in close scrutiny.

Q When you read it with Mr. Trakas in Hornblower's office, you looked through it with him, is that right?

A That's right.

Q Did you look at the statement of assets, intangibles and deferrals, March 31, 1971, the first of the three statements which appears on page 22?

A I looked at this prospectus with him and with nothing in great detail because my understanding of how deferrals and such on a new company would be carried and with the new monies coming in we spoke together that the company would owe no money. That the company would be a very aggressive company. That it was, with the monies we put it, to be in that position.

MRS. BANFIELD: Do you want to read that

last answer back. I think we misunderstood it. The question and the answer.

(Record read)

Q The precise question that I asked you was whether, when you looked over the prospectus with Mr. Trakas, you looked specifically at the statement of assets, intangibles, and deferrals, March 31, 1971, which appears at the top of page 22 --

MR. BADER: You may answer that question, Mr. Thompson and please answer Miss Banfield's questions specifically. She is entitled to a specific answer.

A I read all of these.

Q So you did read --

A I did.

Q -- that statement of assets, intangibles and deferrals?

A Yes.

MR. BADER: I would just like the record to show, Mr. Thompson, when Miss Banfield asks you a question, she is entitled to a specific answer.

Q In the statement of assets, intangibles

and deferrals, under the heading intangibles and deferrals, there is a sub-item, research and pre-operating costs (Note 1).

Do you see that?

A Yes.

Q And reading to the column on the right, what is the figure given for historical research and pre-operating costs?

A $6,075,700.

Q Were you aware, then, when you looked at this prospectus with Mr. Trakas, that the company had, according to its financial statements, incurred over $6 million in what was shown in the financial statements as a research and pre-operating costs?

A As so stated, yes.

Q Did you read Note 1 to the financial statement?

A I read vaguely the notes. I reviewed this balance sheet with him.

Q Is it your understanding today that this is a balance sheet, sir?

A A balance sheet, yes.

Q Did the word balance sheet appear anywhere in the statement?

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A It appeared in this form here. That's what I read.

Q The answer to my question -- I asked you whether the words balance sheet appeared in thi orm?

A Does it appear here?

Q Yes.

A I assume this to be a balance sheet.

Q Will you turn now to Note 1 to the financial statements.

Let the record show that the witness had the assistance of counsel in locating Note 1 to the financial statements.

MR. BADER: Absolutely. The witness wasn't able to find it himself.

Q Looking at that Note 1, sir, the first sentence states that "The company is in the development stage."

Do you recall reading that at the time, before July 13,1971?

A I was informed that the company had developed at this time.

Q Again, sir, my question was whether you were aware, whether you read before July 13, 1971,

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that Cartridge for accounting purposes was a company in a development stage?

A I stated that this was stated to me, that it had been developed, Cartridge T.V. And so far as the footnotes and all on the face of this page, I have previously stated I did not accept myself as an accountant and authority on accounting and naturally, I would not have been aware of how you, as an accountant, would carry this footnote. The stock was recommended to me as an attractive situation.

Q Sir, do you usually read the notes to financial statements?

A I don't purchase stocks of new companies that often enough.

Q Other companies that you purchase stocks of --

Normally speaking, I rely on the people that I purchase stock from to keep me so informed of the condition of the company.

Q Is that what you did here with Cartridge?

A The situation I read here and I do not understand all of the deferrals and all of the new company set ups they were going through. I understood

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Q Well, let's see. The basis of your belief that the company was solvent, though, was what you were told, is that right?

A What I read and what I was told, yes. The two jointly.

Q I am focusing on what you read. What did you read that told you that the company is solvent?

A I read with respect here that the company had such monies in development of course, and that these deferrals here that we were putting new monies in it which would, in effect, make the company -- since the statement was that it was developed, ready to be a company that had monies available to it, to encounter the distance they had to go to put this into the market.

Q From what you read, was the company solvent, to use your term?

A In my opinion, I was buying into a solvent company. Or I would have been out of my mind to buy one that was not.

Q I just want you to put your finger on, point out to me what it was that you read from which you concluded that the company was solvent.

A That this company here had assets --

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Excerpts from E.B.T. of Plaintiff Eddie L. Thompson, Jr.

given to the public offering. And I want to ask you specifically, then, without the public offering, leaving that aside, whether there was anything in these financial statements from which you drew the conclusion that Cartridge was, to use your term, a solvent company?

A Had I had known of this Note 1 of the 6,075,000 was carried in here as an asset, had I been smart enough to realize that these deferrals of operating cost was carried as an asset, I would not have made the purchase. That was misleading to me at this stage.

MRS.BANFIELD: All right, I would like to have that answer read back so I don't mistake it.

(Record read.)

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MRS. BANFIELD: I withdraw the question.

Q Was the fact that the research and pre-operating costs were being deferred disclosed in the notes to the financial statements?

A They were disclosed. My knowledge of how they were carried was not clearly understood.

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as an asset?

A Again I state I do not have knowledge that that could be so done. Salaries are people. In a new company I would have to assume that I would be familiar that your rents, your startup, you had to start somewhere, the costs would be deferrals until such time that cash was made available. As far as Note 1 and 3 which you totally carried in the column -- it was misleading to me.

That is basic on my starting a job. So far as anything that you could defer a purchase of machinery, as you did in this case, all these starting up costs, to me it would have been inconceivable. Even now that you could have a practice that you could just defer without some point of writeoff, and I assume it would have been done at the time the sales started.

Q Did they tell you in the financial statements, sir, or in the notes, when they planned to write off the costs that were being deferred?

A The writeoff costs, I did not understand how it was handled.

Q Did it tell you in the financial statements how they were planning to do it?

A Probably they did. I don't know.

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Q So that I make sure that I understand your answer, I understand you to be saying that you do not today question that the amounts shown as cash receipts and disbursements were the amounts of cash that were received and disbursed for the items shown, is that right?

A That's right. I do not question that.

Q You do, today, question whether the company, perhaps, spent too much money or not enough money?

A I question the expenditure as being gross.

Q When you say gross --

A It was an inflated amount or an unnecessary -- I will put it an unnecessary expenditure but I do not question the figure.

Q They spent the money but in your view they didn't need to spend so much?

A Correct.

Q Would your answer be the same, so that we don't have to go through this whole sequence for travel?

A That would be one that I would certainly say yes.

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an obligation to take down everything you say. So I am afraid you have to say it for him.

MR. BADER: You said it, Mr. Thompson. You say it again.

A I make no denial. All expense accounts are grossly misused.

Q It is your belief that Cartridge spent too much money on that kind of thing based on your general knowledge of how expense accounts are used?

A Yes.

Q And nothing else in particular?

A That's all.

Q Just your general knowledge as a businessman?

A Yes.

Q No particular facts about Cartridge itself that come to mind?

A Nothing.

Q Now we have an item, purchase of invention. $120,000 according to the statement of cash receipts and disbursements.

Do you question the accuracy of that figure?

A The accuracy, but I certainly have no knowledge of what that invention could be.

Q You don't question that they bought an

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Q Was it confusing to you, is that what you said?

A I am saying I accepted it, again, as an asset to the company. I read these as assets. I read it then, assuming that that figure was in its proper place as an asset.

Q Did you have any question in your mind as to that?

A No.

Q No? When you read it?

A I just thought the $29,374,131 was the cash assets of the company.

MR. WILLIAMSON: Would you read back the last part of that answer, please, Mr. Reporter.

(Record read)

Q Did you read the notes to the financial statements in that annual report?

A I do not recall of having read the notes of 1971. I had already made investments in the company. I was still buying the stock under recommendations and from the figures that I had here, I thought the company had that amount of money. As an unsophisticated investor, I don't think I can read every item that's detailed. If the stock is

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so recommended to you and you have the same faith on that person that you had the confidence in, most anyone would omit some of the readings of the financial statement of such.

Q Would you turn to page 12, the last page. Do you see the report there of independent certified public accountants?

A Yes.

Q Did you read that?

A I do not recall having read that. Possibly did, but I do not have --

Q Well, I am going to read the second paragraph of the report for the record.

"As discussed in note 1, the company has incurred significant amounts of research and pre-operating costs, which costs have been deferred. The company has also acquired substantial production facilities and equipment. In addition, the company expects to incur substantial additional expenditures to complete development of its products and production techniques and to acquire property, plant and production equipment. It is not possible at present to determine whether these costs ultimately will be recovered since recovery is dependent upon

* * * *

Q Mr. Thompson, do you question the accuracy of that figure, that is, that Cartridge had incurred during the year ended November 30, 1971, that amount attributable to research and preoperating costs?

A Again I say no accuracy to the figures but grossly expended.

Q To elaborate on that a bit, sir, you do not question the accuracy of the figures, is that correct?

A Right. I just question the research and preoperating costs in all instances. Everywhere it appears.

Q You think it might have been too high?

A I think it might have been too high. I think there might have been things that were questionable that should have gone to research and development. As far as the figures, I do not question any of your figures. I have every reason to believe that all of them were expended. The manners in which they were expended is what I question.

Q Incidentally, for the record, you understand, do you not, sir, that these are financial statements of Cartridge Television, Inc.?

A Yes, I do.

Q They are not prepared by Arthur Young.

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Q Are there some costs which a company in a pre-operating stage are incurred that you wouldn't consider to be pre-operating expenses?

Would you like to have the question read back?

A Please.

MRS. BANFIELD: Read it back, please, Mr. Reporter.

(Question read)

MRS. BANFIELD: I think I will withdraw the question on hearing the question re-re-read and see if I can make it a little more clear. It didn't sound very clear to me when it was re-read.

Q Let's suppose a company is in the pre-operating stage, which is to say, it hasn't made any sales yet. Are the costs which it incurs while it's a pre-operating company, pre-operating costs?

A All the costs related to product, to the buildings and to the facilities, I would say yes. If there were any excessive costs that were not included, related to that product, the answer would be in the negative.

Q Those you would consider to be pre-operating costs?

A That's correct.

Q Or at least not proper pre-operating costs.

A Not proper. It would be a judgment cost.

Q I don't believe I have heard that term before. What does it mean? Can you tell me what it means?

A Pre-operating costs there, or I stated if it was related to the manufacturing of the product or the facilities, that it would be in my opinion considered a pre-operating cost.

Q And if it was excessive, you said you would consider it something else.

A Correct.

Q And you used a term for that. Did you say judgment cost?

A Judgment. Decision to make as to whether or not that would be considered pre-operating costs or as to whether it would be expense or how. I don't know how -- I would be prepared to draw the line. I am not a professional.

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Q Well, now, in suing Arthur Young here, you have drawn the line, haven't you? You claimed that some of these costs were not proper pre-operating costs, is that right?

A I have.

Q And which costs are those?

A The pre-operating costs in here, if you are referring to those -- I so also stated that they would be -- some of those presented upon discovery.

Q You have no knowledge of it at this time?

A No.

Q You just suspect that there are some possibly?

A Correct.

Q Do you have any information from anybody else that there are?

A I do not at this time.

MRS. BANFIELD: I have here a Xerox copy of the annual report for the year 1972 of Cartridge Television, Inc., which I would like the reporter to mark as Defendant Arthur Young's Exhibit 51 for identification, please.

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Now, in the response to interrogatories, the middle of page 7, paragraph 6A, it states that "The sum of $7,509,000 set forth as 'additional pre-operating costs' was actually for current operating expenses."

Do you have knowledge as to whether that's the case, Mr. Thompson?

A No. I have to assume that the pre-operating costs there will include items other than related to the development of the system itself.

Q Well, do you have any knowledge as to whether the sum of $7,509,000 was actually going to be spent on current expenses?

A I do not have that knowledge.

Q Turn to page 4, sir, of the prospectus. In the last paragraph, use of proceeds. The second sentence I will read out loud.

"The company will use these net cash proceeds to defray its additional pre-operating costs (estimated at $7,509,000 as of March 31, 1971, of which approximately $1,173,000 will be used to reimburse AVCO for startup expenses to be incurred in connection with production of Cartrivision

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recorder playback units). . ."

Looking back to the answers to interrogatories, page 7, item 6B, it says "The sum $1,173,000 was not proper start up expenses in connection with production of the Cartrivision recorder playback units."

What's the basis for that statement, sir?

A These never came to the market. I have to assume that they never brought these forward, so I can't see -- in stating this, I cannot ascertain anywhere that this money was used for that purpose.

Q Well, if it had been used for that purpose, would it have been a proper startup expense?

MR. BADER: Objected to as theoretical, calling for a conclusion.

MRS. BANFIELD: I can ask a hypothetical question, Mr. Bader.

MR. BADER: No, you can't. I instruct the witness not to answer that.

Q On page 8 of the answers to interrogatories, item 8:

"The prospectus failed to disclose that

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the so-called 'deferred research and pre-operating costs' were actually expensed for income tax purposes." And I'll stop the quote there.

Did the prospectus say anything, sir, about the treatment for tax purposes of the deferred research and pre-operating costs?

A I am not familiar with that.

Q I would like to draw your attention to note 5 from the financial statements on page 26 -- Mr. Thompson can find it, Mr. Bader. It saves time.

MR. BADER: Sure. I have to find it myself. And you can help him follow it.

Q I will quote, reading from note 5 of the prospectus:

"Research and pre-operating costs which the company has deferred for financial statement purposes, note 1, are claimed as deductions for federal income tax purposes in the year incurred."

Having read that, do you agree that the prospectus failed to disclose that so-called deferred research and pre-operating costs were expensed for income tax purposes?

Q If they are so in the records, then I

would say it was stated here.

Q It was stated in the prospectus?

A Yes.

Copy received
Aug 12, 1975
Ernst & Ernst
Atty for Appellant

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